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What’s next for Latin America?

AFTER the “lost decade” of the 1980s and the financial crises of the mid- and late-1990s and early years of this decade, Latin America is enjoying some much-needed breathing space. Growth has been strong during 2004–05, the destructive hyperinflation that once seemed characteristic of the region is an increasingly distant memory, and the economies of the region have been showing encouraging resilience to shocks. But what’s next? Poverty in the region is still extremely high, the gap between rich and poor is the widest in the world, and progress on social indicators has been painfully slow. In fact, Latin America may be the only region, along with sub-Saharan Africa, not to reach the Millennium Development Goal of halving the 1990 level of income poverty by 2015. This social picture not surprisingly feeds into the political arena, which will be unusually active in the year or so ahead with elections across the region—including in the two largest countries economically, Brazil and Mexico. Thus, voters will have a chance to shape the region’s economic agenda for years to come.

Against this background, the December issue of *F&D* takes a close look at Latin America, ranging from the overall economic picture to troubling social issues, including the plight of indigenous people. As part of our coverage, we bring in some regional viewpoints—one from Arminio Fraga, the former head of Brazil’s central bank (1999–2002) who helped put an end to the country’s hyperinflation; and another from Arturo Valenzuela, Director of Georgetown University’s Center for Latin American Studies and former Senior Director for Inter-American Affairs at the U.S. National Security Council (1999–2000). In “People in Economics,” we profile Nora Lustig, the Argentinean-born development economist who broke ground with the concept of “socially responsible macroeconomics”—a call for policies that protect the poor during times of crises and simultaneously help lower chronic poverty.

* * * * *

In “Back to Basics” and “Picture This,” we examine remittances—the flow of funds (either cash or goods) typically from migrants to their families at home. A recent World Bank study reveals that these flows are now the second largest source of external finance worldwide, and for some countries, the largest source of foreign exchange inflows. In recent years, the international community has stepped up efforts to enhance the development impact of remittances; one pro-poor measure would be to cut the costs of sending them in the first place. This issue of *F&D* also explores another source of funds that is growing at a remarkable pace (largely driven by growing oil wealth): Islamic finance. We learn that a sound, well-functioning Islamic financial system could help economic and social development in the numerous countries involved by financing economic infrastructure and creating badly needed jobs.

Laura Wallace
Editor-in-Chief

Illustration: cover (“Del Cielo a la Tierra”) and p. 8 (“Universo mi País El Salvador II”), Fernando Llort; p. 26, Massoud Etemadi.

Survival of the fittest

In “Risky Business” (September 2005), Raghuram Rajan argues that skewed incentives for investment managers may be adding to global financial risks. As savings have been disintermediated and increasingly channeled toward investment managers and away from banks, risks have increased because investment managers have a higher incentive to take risk. The key to his argument is that investment managers—as opposed to bank managers—face a compensation structure with a large upside and little downside, thus skewing their investment decisions toward riskier behavior.

I would like to disagree. Taking it to the extreme, there are two types of incentive structures. On the one hand, bank managers receive a large salary and a small bonus based on the general profitability of their company. Failing performances do not lead to serious punishment, for they are blurred into the overall results of the bank. On the other hand, absolute return high risk investment managers receive a proportionally smaller salary and a larger bonus based on individual performance. The investment manager can reap the profits of a successful performance, but he or she can also lose everything in a failing performance and be out of a job. Absolute return investment managers thus play a continuous survival game, where the key objective is to be able to play the following day. These pressures are what introduce discipline into their actions, resulting in profit maximization.

The symmetric definition of limited liability places absolute return investment managers in a superior risk-reward position. Relative return investment managers (for instance, mutual fund managers) do not face this structure, though, and may be closer to the skewed incentive structure that Mr. Rajan comments on and finds problematic.

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Not just for profit

Fe-D has once again presented a serious, critical, and in-depth look at elements of the global economic system, this time in its articles on making aid work (September 2005).

That said, a few matters may not have been accorded enough importance. First, the globalizing economic system is generally arrayed against the real goal of development, which, in my view, is to help poor people improve the quality of their lives. The corporations, banks, and individuals who exercise de facto control over the global economy are driven mainly, if not exclusively, by the effort to maximize profit. Profit is not, of course, intrinsically evil. But to subordinate everything to it—including the well-being of hundreds of millions of people—is.Crudely stated, if the development community cannot restrain the power of finance capital, then development, in terms of meeting the Millennium Development Goals (MDGs) for instance, will never be achieved.

Second, I found mention of the external debt of developing countries only in the essay on “The MDGs: Building Momentum,” and even there, only as a kind of afterthought. The debt question has been front and center for many years. The new debt relief initiative launched by the Group of Eight (G8) countries is yet another attempt to address it, but to many observers, no debt relief initiatives have succeeded so far. The debt is both a psychological and an economic obstacle to effective development in the developing countries. The conditionalities that have been attached to all debt-reduction approaches simply perpetuates the problem.

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We welcome letters
Please send no more than 300 words to fandletters@imf.org or to the Editor-in-Chief, Finance & Development, International Monetary Fund, Washington, D.C., 20431, USA. Letters may be edited.
Bird flu action plan

Governments and United Nations agencies have developed a six-point global action plan to preempt a deadly human pandemic of bird flu, which a World Bank analysis estimates could cost the global economy $800 billion if it occurred. The global plan seeks to control avian influenza in animals and simultaneously limit the threat of a human pandemic. Funding to help countries take preventive measures will be funneled through the World Bank and the Asian Development Bank.

Key components are:

- **control at source in birds**—improving veterinary services, emergency preparedness and control (including culling, vaccination, and compensation), and helping countries curb avian influenza in animals.
- **surveillance**—strengthening early detection and rapid response systems for animal and human flu, and enhancing laboratory capacity.
- **rapid containment**—training for investigation of animal and human cases and clusters, and planning and testing of rapid containment activities.
- **pandemic preparedness**—building and testing national pandemic preparedness plans, conducting a global response exercise, enhancing health systems, and training clinicians and health managers.
- **integrated country plans**—developing national plans across all sectors to provide the basis for coordinated technical and financial support.
- **communications**—factual and transparent communications, in particular risk communication, which is vital to support the other elements.

“Many countries where the disease is endemic have already taken action, but they are overwhelmed by the situation and require urgent assistance,” UN Food and Agriculture Organization Assistant Director-General Louise Fresco said recently. “Fighting the disease in animals is key to our success in limiting the threat of a human pandemic.”

Digital divide harms growth

Developing countries in Africa and other regions face a competitive disadvantage because their businesses have difficulty accessing the Internet, according to a report by the United Nations Conference on Trade and Development. The Information Economy Report 2005 shows that while in some poor regions the number of Internet users has grown substantially, overall the gap between developed and developing countries remains wide. For example, while 89 percent of enterprises in European Union nations are connected to the Internet, the same is true of only 5 percent of firms in Mauritius and 9 percent in Thailand.

Tourism is one example where developing countries could benefit from the Internet economically, the report notes, because many trips are now planned, booked, and paid for online. Banking and e-business are also growth areas.

Africa fighting desertification

African governments and donors have launched an ambitious plan to fight desertification, which causes chronic food shortages and threatens to drive millions from their homes in coming decades. The Terrafrica partnership aims to attract at least $4 billion over 12 years to improve the sharing of ideas about how to combat land degradation, according to officials meeting in Kenya in October. The United Nations estimates that 65 percent of Africa’s 800 million population is affected by land degradation, mainly in areas where forests have been cleared to make way for agriculture and overgrazing.

Work longer

Employment ministers in industrial countries have agreed that more must be done to encourage older people to remain in the workforce. If nothing changes, the number of retirees will increase significantly over the coming decades while the number of employed persons will stagnate. In European countries, it is expected that, by 2050, for every retired person there will be only one person in employment. This will put pensions at risk and increase tax pressures on the working population. Ministers meeting in Brussels in October said early retirement should now be discouraged, and employers should be encouraged to retain or hire older workers.
Economics, long known as the dismal science, usually examines issues with clinical detachment. But Nora Lustig has spent her career trying to give it a conscience. She has been in the vanguard of development economists who not only insisted on the link between poverty reduction and macroeconomic policy but also advocated well-targeted social policies to help the poor break out of poverty for good. For a long time, “there was a sense that poverty reduction had to be done through growth, which seemed to imply that policy measures that aimed directly at poverty reduction weren’t as important,” she tells F&D. “But I think that we have shown that both are very important. If you want to reduce poverty more quickly with growth, you need policies that have a very profound impact on equalizing opportunities in many respects.”

Lustig’s curiosity about the causes of inequality and poverty and her drive to find solutions have been at the core of her work, which she has undertaken in academia, think tanks, and as an advisor to policymakers. Meticulous in her use of empirical data, she is credited with injecting a somber and scientific note into the often ideologically charged development debate in Latin America. “Lustig is unusual in that she is one of the few academics who has managed to be involved in both Latin American policy work, particularly in Mexico, and the Washington academic and multilateral organization world,” says Andres Velasco, Professor for International Finance and Development at Harvard. “She brought perspective to the latter and rigor and discipline to the former.” Lustig relentlessly pushed to include analysis of the effects of such factors as income distribution, education, and health care in the debate on overall economic development, which was dominated by macroeconomic concerns. She broke ground in 1999 with the concept of “socially responsible macroeconomics”—a call for policies that protect the poor during times of crisis and simultaneously help lower chronic poverty.

After the emerging market crises of the 1990s, the message sunk in, and multilateral agencies and developed countries realized that the process of eradicating poverty and achieving sustained development had to involve the poor as active participants. “It has to do with human behavior, and with the need to empower the poor to gain access to economic development,” Lustig explains. Poverty reduction now tops the world’s economic agenda. Just 15 years ago, Lustig points out, poverty was not even peripherally discussed at the Group of Seven industrial country summits. Now, in contrast, the world’s economic movers and shakers are actively exploring innovative ways to aid poor people—such as investing in early childhood development, educating women, and promoting microfinance—all topics dear to Lustig’s heart.

Yearning to question

Born in 1951 in Buenos Aires, Lustig was the child of Austrian immigrants who had fled anti-Semitism in pre–World War II Europe. Although her parents worked hard, her father as a watchmaker and her mother as a bookkeeper, they found it difficult to break out of the lower-middle-class mold, given Argentina’s economic instability in the 1960s. That, coupled with latent anti-Semitism, prompted the family to move to the United States in the late 1960s, settling in the San Francisco Bay area. Lustig enrolled in Oakland’s Merritt Junior College, a primarily African-American community college famous for being the birthplace of the Black Panther movement. After qualifying for in-state tuition, she transferred to the University of California at Berkeley, where she obtained her Bachelor’s and Ph.D. in economics. During Lustig’s first years, Berkeley and other university campuses in the United States were gripped by student protest against the Vietnam war and support for the civil rights struggle.

But political activism was not her calling. Instead Lustig focused on examining the economic disparities within and across countries through academic research. Her thesis advisor, Albert Fishlow, now at Columbia University, recalls that “her principal focus was always on having an empirical basis for economic policy. She wanted to have the facts.” In her dissertation, she used empirical verification to test hypotheses by Latin American economists about the effect of inequality on growth. Examining the relationship between income distribution, consumption, and growth in Mexico, she found that general conclusions could not be drawn. It taught her the importance of never ceasing to query. “Science requires us to always question what you’ve discovered today in case the evidence will suggest something different tomorrow,” she says.
Her research took place at a time when most Latin American economies were relatively closed, and state intervention was rampant. Economic thinking was somewhat paralyzed by the political polarization associated with the Cold War. While U.S. universities kept close to the mainstream economic theory promoting free-market principles, many Latin American universities were inclined to Marxist/Socialist concepts. This was frustrating at times, she says, because it stifled constructive debate. Only with the end of the Cold War did views begin to merge into the broad consensus that changes in inequality and poverty would come through reforms, not revolution. “The fall of the Berlin Wall greatly benefited the field of economics,” she says, “because people opened their minds and accepted that there may be more than a single route to economic development.”

Learning from Mexico

While completing her dissertation in 1979, Lustig taught economics for 14 years at the prestigious Colegio de Mexico, where she had moved with her husband, a Mexican economist, whom she had met at Berkeley. She was still teaching when the 1982 debt crisis hit, seeing first-hand the impact on the poor. Struck by the Mexican government’s scaling back of a pro-poor program that had already been very small to begin with, Lustig took a closer look at the social impact of crises and economic policies. She summarized her findings in the book *Mexico: The Remaking of an Economy*, which she published in 1992 while she was a Senior Fellow at the Brookings Institution. The book, which won the 1994 Outstanding Book Award from *Choice* magazine, a U.S.-based academic journal, examined Mexico’s outward-oriented development strategy and its effects on poverty and inequality. It was published at the height of what was called “Mexico-optimism” when Mexico was viewed as the model reformer among developing countries. Although upbeat about Mexico’s economic prospects, Lustig did not share the euphoria, which came to an abrupt halt with the 1994/95 peso crisis.

Despite an unprecedented rescue package of more than $50 billion, which included $20 billion from the United States and $17.8 billion from the IMF, Mexico was unable to avoid its largest recession since the 1930s. In the 1998 update of her book, Lustig wrote that although it was hard to quantify the recession’s impact on the poor for lack of direct information, several indicators suggested that it must have been severe, which was subsequently corroborated by the sharp rise in the incidence of poverty between 1994 and 1996. Mexico did not have adequate mechanisms in place to cope with the sharp rise in unemployment and steep drop in wages. The biggest losers in a crisis are always the poor, she says. “The most common reason for large increases in poverty in the short term is economic crisis.”

Lustig realized then that the effect of a sharp rise in poverty on long-term growth had been grossly underestimated, if not entirely neglected, because economic policies had focused mainly on macroeconomic stabilization and paid little attention to social factors. But, she insists, it is important to include them in policy considerations. An
economic crisis like the one in Mexico forces poor people to decimate their already small financial, physical, and human assets, and thus traps them at an even lower level of income, and further reduces their chances of contributing to the country’s economic growth. “If children are being pulled out of school, or babies do not receive the right nutrition because the mothers don’t have access to it, they have a slimmer chance of advancing later in life and becoming productive participants in the economy.”

Her research and writings became mandatory reading for a new generation of Latin American economists, who were drawn to her resolute advocacy of pursuing macroeconomic stability while seeking intelligently designed social policies. “What appealed to students like me was that she tackled the issues in a very serious way,” says Luis Felipe Lopez Calva, Economics Professor at Mexico’s Tecnológico de Monterrey and Director for the UN’s biannual Mexican Human Development Report. “In Mexico, more people in economics are working on poverty and inequality issues using rigorous methodologies because of her.” Indeed, because of her thorough analytical approach, Lustig was able to breach the intellectual divide between different schools of thought on economic development and bring together researchers and practitioners (see Box 1). “She has a lot of good ideas and she puts them into action,” says Lopez. “She aims quite high, but she always delivers.” Lustig also sits on the Boards of Directors of the World Institute on Development Economics Research, the Center for Global Development, and the Earth Institute. She has served on various commissions, including the World Health Organization’s Commission on Macroeconomics and Health, and she now presides over the Mexican Commission on Macroeconomics and Health.

**Champion for safety nets**

When Lustig joined the Inter-American Development Bank (IDB) in 1998 as Senior Advisor on Poverty and head of the newly created Poverty and Inequality Advisory Unit, she built on the Mexican experience to draw attention to the importance of well-targeted safety nets in the face of systemic shocks. She argued that adequate safety nets need to be in place before the advent of shocks—macroeconomic crises, large-scale natural disasters, or widespread disease—and before the negative effects of profound structural reforms, such as trade liberalization, affect poor producers who cannot compete in the short run. “Protecting the poor from sharp income falls with efficient and properly funded safety nets is not only equity-enhancing, it also promotes growth,” she says. The impact of crises on child malnutrition and school attendance can be long-lasting. A pro-poor response to crises should be an integral part of a country’s poverty reduction strategy. “On poverty issues, Nora was ahead of the game. She was the first to pay attention to the safety net issues,” says Nancy Birdsall, president of the Center for Global Development.

Lustig believes that to remain effective in the long term, these social programs have to be part of the established institutional framework, adjusting to economic circumstances when necessary. “Safety nets should be flexible, and the allocation of public resources to programs targeted at the poor should be countercyclical.” In other words, during times of broad-based economic growth that benefits a majority of the population, social programs can be scaled down, but during times of economic distress, they should be expanded to prevent poverty from rising. For example, employment programs have been applied in some countries on a regional basis, she says, citing a renowned rural employment program in India that is activated when crops fail. But Lustig is impartial as to the shape and form of such programs (see Box 2).

To learn which types and components of social programs work, their impact needs to be evaluated rigorously and empirically, Lustig insists. But reliable data on factors that help measure and diagnose poverty—such as income, education, gender, employment, demographics, and location—have long been sparse in Latin America. For that reason, one of her key projects at the IDB was trying to improve the quality of household surveys on income and living conditions within the region. She pursued impact evaluations of poverty reduction programs within the IDB’s lending operations and initiated multiyear studies on social protection systems, labor market regulations, and other public programs. “She was the architect of the work on poverty,” says Birdsall, then the IDB’s Executive Vice President. Out of this work also grew a project with the World Bank on income distribution in three East Asian and four Latin American countries, which culminated in the 2005 book *The Microeconomics of Income Distribution Dynamics*, edited by François Bourguignon, Francisco Ferreira, and Lustig. With

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**Box 1**

**Sharing knowledge**

Lustig, who has always gone to great lengths to advance debate, says “you need to share your findings and insights in order to make progress.” In the early 1990s, she helped launch the Latin American and Caribbean Economic Association (LACEA), today the primary organization for researchers and practitioners focusing on the region’s economies. “Nora really deserves the credit for envisioning this forum and for successfully achieving regular meetings in the early stages,” says Albert Fishlow, LACEA’s first president. Lustig, who presided over the association in its second year, also set up the Network for Inequality and Poverty, an initiative to link up with the World Bank and the Inter-American Development Bank (IDB), and in 2000, initiated LACEA’s reputable journal *Economía*.

At the IDB, Lustig, together with Nancy Birdsall, then IDB Executive Vice President, and Eduardo Aninat, then IMF Deputy Managing Director, launched the Social Equity Forum, bringing together officials from multilateral organizations, civil society groups, and academics. She says these deliberations helped to bring the message home on the importance of providing adequate safety nets during aggregate shocks, which has become pretty much standard knowledge now."
by the team from the very beginning: to emphasize empowerment, and security. Despite the controversy, the systemic problems that keep the poor and disadvantaged from advancing economically and the economies from realizing their full potential.

Attacking poverty
While at the IDB, Lustig was tapped by the World Bank to be deputy director for the 2000/01 World Development Report (WDR) on poverty. When the project became shrouded in controversy and lead author Ravi Kanbur resigned before publication, Lustig was asked to take over. Concerns had been raised about the analytical underpinnings of the early drafts of the report and its overall message, which was seen in some quarters as too critical of IMF- and World Bank-sponsored structural adjustment policies, with too little emphasis placed on growth. Lustig countered the apprehension by circulating the final draft to a broad range of international experts of diverse views for comment. The final report, entitled “Attacking Poverty,” urged a broader, more comprehensive approach to poverty reduction by tackling inequalities directly through greater economic opportunity, empowerment, and security. Despite the controversy, Lustig “stuck to her guns under a lot of pressure and very little time,” says Birdsall, achieving what had been envisioned by the team from the very beginning: to emphasize empowerment and the reduction of inequalities as an essential part of a poverty reduction strategy. Reaction to the report from all sides was broadly positive, and Oxfam called it “a flagship document that the World Bank can be proud of.”

Lustig says that by emphasizing the concept of empowerment, the WDR made clear that poverty reduction could not be treated as social engineering. “The WDR brought to center stage the institutions and rules of the game in the world system as part of the poverty reduction agenda.” The 2006 WDR on equity and development advances this notion further, arguing that policies that level the economic playing field can be successful only if accompanied by similar efforts to level the domestic political playing field. Lustig wholeheartedly agrees, noting that “change will have to come through the political process and more democratization.” But she adds that in Latin America so far, “the countries’ elites have not done their share to change the rules of the game.”

Coming full circle
After Washington and a four-year stint as president of Mexico’s prestigious Universidad de las Americas in Puebla, Lustig recently returned full-time to academia. In September 2005, she launched the Study Center on Globalization and Development at one of Mexico’s top private universities, the Tecnológico de Monterrey. As its director, Lustig is emphasizing those elements that have characterized her own career: encouraging empirical study and analysis; sharing knowledge and exchanging ideas; and bringing together opinion leaders and policymakers.

She plans to disseminate a newsletter throughout Latin America. And she wants to help small producers gain access to global markets by teaming up grassroots organizations and other groups, including the university’s business school and local governments. She calls this “making globalization work for the poor.” Lustig intends to maintain close ties to Mexico’s political scene, and as the foremost economist on poverty issues in Mexico, her advice is sought by a wide range of political players. Her spare time is saved for friends and family—her son and daughter are in college—and dabbling in semi-abstract oil painting.

With the battle against poverty now at the top of the world’s agenda, Lustig is looking forward to fully engaging in the debate again. She says the consensus underlying the Millennium Development Goals is a good incentive for governments to implement the appropriate policies. She is pleased that the debate has reached a point where “people are not repeating mantras anymore,” but instead are focusing on the systemic problems that keep the poor and disadvantaged from advancing economically and the economies from realizing their full potential.

References:
Latin America’s Resurgence

Region has fresh chance to entrench growth and break cycle of crises

Anoop Singh and Charles Collyns

LATIN AMERICA often appears to lurch from the cusp of success to the depths of crisis, so to talk about resurgence invites skepticism. Nevertheless, much of the region has witnessed a swift and robust recovery from the successive financial crises of 2001–02. Within two years, the region’s economic growth reached 5.6 percent in 2004, a 24-year high. Growth rates of about 4 percent in 2005 and 3 ½ percent projected for 2006 are well above historical averages.

Since the so-called “lost decade” of the 1980s, Latin America has made progress on several fronts. Just 25 years ago, military dictatorships outnumbered civilian elected governments by two to one. Today the region is in the midst of an election cycle that will set the policy agenda and shape the continent for years to come. Destructive hyperinflation is becoming a dim memory, and Latin America is building resilience to external shocks by adopting market reforms and entrenching sound macroeconomic policies—raising the prospect that the current expansion will be more enduring than in previous cycles.

However, persistently low per capita income growth, high or rising poverty, and rates of inequality that remain among the highest in the world (see “Stuck in a Rut” on page 18) have risked undermining popular support for reform programs launched during the 1990s that held out great promise but often yielded disappointing results—especially relative to other emerging market countries. Targeted social programs have helped meet specific needs, such as raising literacy and health standards, but interrupted reforms and growth, and recurring financial crises, meant that broader social improvements remained elusive—especially for the bulk of indigenous peoples (see “Latin America’s Indigenous Peoples” on page 23). Thus, there has been a growing sense in many countries that the benefits of global integration have been unevenly distributed, accruing primarily to those in upper-income brackets, while the costs have been borne by the less-wealthy majority. In a few countries, there has even been a growing militancy among disenfranchised groups.

Given that many Latin American countries, including the largest, are holding elections over the next year or so (see map), the central question is whether the recent resurgence can be sustained once the global environment—still relatively benign despite high oil prices—becomes less friendly. After all, sustained, and even higher growth is critical to making a decisive impact on social and poverty indicators that remain weak with national poverty rates exceeding 40 percent of the population and secondary school enrollment averaging 62 percent. To provide perspective, this article draws on experience since the start of market-based reforms in the early 1990s to highlight policy priorities for the future.
Better performance
Latin American economies have generally performed well in the past two years. Growth has been significantly above historical averages, particularly in commodity-rich economies that have benefited from robust global demand (see Chart 1). Mexico and South American countries have gained, in particular, from the surge in fuel, food, and metals prices, and have generally been able to exploit these opportunities by expanding production—in some cases very substantially—although most oil exporters have not been able to do so.

Inflation has stabilized in single digits, after a brief uptick. External positions have strengthened as booming exports have helped generate current account surpluses. Easy global liquidity conditions have contributed to capital inflows and rising international reserves (see Chart 2). And the recovery has also been better balanced than past episodes, with less reliance on domestic demand (see Chart 3).

This recent improvement in performance reflects policy efforts over a number of years that are now bearing fruit—with some countries, such as Brazil, Chile, and Mexico, leading the way (see box). What are the key elements? Every country is different, but there are several common factors.

Low inflation. The 1990s saw the establishment of low inflation, a striking achievement for Latin America, given its earlier record of high inflation. An important reason has been the emergence of widespread public awareness of the need to bring inflation down, leading to popular resistance to policies that would risk reigniting inflationary pressures, anchored by improved frameworks for monetary and fiscal policies.

Policy flexibility. The adoption of market-determined exchange rates by many Latin American countries has greatly improved the flexibility and resilience of the macroeconomic policy frameworks. In parallel, the region has also successfully developed a more robust basis for monetary policy by moving away from exchange rate anchors and toward growing reliance on inflation-targeting regimes and autonomous central banks. The success of the region’s inflation-targeting regimes and the willingness of country authorities to tackle inflationary pressures at an early stage have bolstered the credibility of monetary policy and contributed to prospects for a more durable recovery (see Chart 4).

Stronger fiscal positions and lower public debt. From 2002 to end-2005, the public debt-to-GDP ratio for the region is projected to fall by about 19 percent of GDP, with declines in virtually all the major countries (see Chart 5). The strengthening of fiscal positions through the generation of primary surpluses has been a major step forward—in contrast to the expansionary policies that led to large deficits during previous periods of easy access to international capital markets. Lower debt ratios have been supported by buoyant economic activity, exchange rate appreciations, and—in the case of Argentina—debt restructuring.

Improved external positions. The present upturn has been driven by strong and geographically more diversified exports and terms-of-trade gains. The resulting current account surpluses have raised reserves markedly and have significantly cut dependence on external capital inflows. This contrasts with earlier episodes, when capital inflows and domestic demand fueled much of the upswing, leading to wider current account deficits and overvalued currencies.
Reduced external financing vulnerabilities. The better fiscal and current account positions have helped Latin America keep external issuance of bonds, equities, and loans well below the peaks of the late 1990s. Near-term vulnerabilities have also been reduced, as many governments in the region have taken advantage of the current benign international financial conditions to prefinance coming debt payments ahead of a full election calendar, and potentially less favorable global market conditions, in 2006.

Expanded domestic capital market role. Several countries—notably Brazil, Chile, Colombia, Mexico, and Peru—have increased their reliance on domestic debt issuance, reducing their vulnerability to exchange rate risk and increasing liquidity in local currency markets (see Chart 6). Some countries, including Brazil, Colombia, and Uruguay, have also issued external bonds in local currency.

Institutional development. Economic institutions have become stronger, although the experience is highly differentiated by country and has not been uniformly sustained. The most rapid improvement was in the early 1990s, with some regression during the financial turbulence of 2000–02. Improvements include the evolution of more autonomous central banks (see “Taming the Monster” on page 26), stronger fiscal management in a growing number of countries, better management of public enterprises (including through privatization), and stronger financial regulation and supervision.

Perceptions: falling short

Yet despite the better economic conditions, Latin Americans continue to express a high degree of frustration with results that fall short of their expectations. Successive surveys by the opinion research group Latinobarómetro show that while there is strong support for democratic governments over authoritarian regimes—as well as for maintaining market economies—people are dissatisfied with the level of economic progress, the privatization of public services, the trustworthiness of public institutions, overall governance, and the amount of corruption. Many feel that their country has been governed for the benefit of a few powerful interests. And well over half believe that it would take more than 10 years to tackle corruption in the region, with a third believing that corruption will never be eliminated.

Foreign investors are similarly frustrated with the high level of corruption. Indeed, cross-regional comparisons of the business climate generally portray Latin America in a poor light. The World Economic Forum’s Global Competitiveness Report suggests that Latin America ranks well behind emerging Asia and Europe, and is falling further behind, especially on the quality of public institutions and technical innovation—shortcomings that reduce incentives for investment and entrepreneurship.

Setting priorities

Going forward, it is vital to build on the foundations for higher sustained growth, not only to insure against external risks—the strong global commodity prices and demand that have partly underpinned strong export growth may not last—but also to close the gap in growth performance with external environment is favorable and economic growth strong. The fiscal surpluses have been used to prepay government debt, reducing debt-to-GDP ratios. This, along with ratings upgrades and low world interest rates, has contributed to record-low sovereign spreads, well below the average for emerging markets.

The full-fledged inflation-targeting framework—the central bank aims to keep consumer price inflation within a 2–4 percent target range over a 12–24 month horizon—that has been in place since 2000 has been successful in reducing inflation while allowing the peso to float freely. Indeed, inflation averaged 2.4 percent a year during 2000–04, down from about 8 percent in the mid–1990s.

What is Chile’s secret for success? Prudent fiscal policies, a move to inflation targeting, a freely floating exchange rate, and trade openness (with average tariffs of only 2 percent) tell much of the story.

Chile’s fiscal rule, in place since 2000—a cyclically-adjusted surplus of 1 percent of GDP in the accounts of the central government—has been instrumental in providing an effective countercyclical stimulus while bringing down public debt. It has allowed the government to run deficits when economic growth is below trend and to accumulate surpluses when the

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**Chart 3**

Better balance
The recovery this time round features positive growth in net exports.

<table>
<thead>
<tr>
<th>(annual average percent growth)</th>
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</thead>
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<tr>
<td>1990-93</td>
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<tr>
<td>Consumption</td>
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Source: IMF staff.

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**Chile: A star performer**

For many in Latin America, Chile’s economic performance in recent decades is enviable. From 1982–97, its rate of growth averaged 6½ percent, with per capita income more than doubling. Although growth slowed during 1998–2003, reflecting in part the regional financial crisis, it rebounded in 2004 and has held strong in 2005. This robust growth, combined with macroeconomic stability, helped bring down poverty from about 39 percent in 1990 to 19 percent in 2003.

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other dynamic emerging market regions and reduce poverty. While the overall impact of the recent increases in oil prices on the region’s growth prospects has been small thus far, a further surge in oil prices could weigh on growth in partner industrial countries, weaken robust world demand for non-fuel commodities, and reverse some of the improvements to the trade balance realized since 2002. Oil-importing countries, especially those in Central America, have already been particularly affected.

For the region as a whole, the risks related to a slowdown in growth in China are rising—even though China’s share of total regional exports is still modest. Exporters of some key products (such as iron ore, soybeans, and copper) would be particularly exposed since China constitutes a significant proportion of their world consumption.

Widening risk spreads for emerging market countries would also harm fiscal and external positions in many countries. The region has benefited from the unusually low level of global interest rates, which has encouraged a “search for yield” and bid down spreads on emerging market debt. Although countries in the region have used this favorable environment to strengthen fiscal positions and debt management, debt-to-GDP ratios in many countries remain very high—generally above 50 percent of GDP—and there remains a high dependence on exchange rate-linked and short-term instruments. Thus, Latin America is vulnerable to sudden shifts in global capital market conditions.

To counter these risks, Latin American governments need to act on several fronts. First, **to reduce macroeconomic vulnerabilities, policymakers should focus on:**

**Reducing public debt.** Despite recent progress, debt ratios continue to exceed the average of the mid-1990s, and generally remain above levels deemed conducive to sustained growth and broader macroeconomic stability, especially for countries with a history of default and high inflation. There are grounds for optimism because of the institutional strengthening that has taken place in many countries in recent years; in this context, fiscal rules and responsibility laws have proven helpful in containing discretionary procyclical spending in a number of Latin American countries, including Brazil, Chile, Colombia, and Peru. For oil exporters such as Ecuador, Mexico, and Venezuela, today’s high prices provide an exceptional opportunity to further reduce public debt. Further efforts to curb nonessential expenditures, broaden and boost revenues, and improve budget flexibility would also spur growth by making room for increased spending on productivity-enhancing and poverty-reducing physical and social infrastructure.

**Keeping inflation low.** Notwithstanding the remarkable progress in reducing inflation, scope exists to further entrench these gains, especially in the face of higher and more volatile oil prices. For example, sustaining the credibility of inflation-targeting frameworks that have helped anchor inflation expectations in a number of large Latin American countries will require keeping exchange rates flexible. Further steps to enhance central bank independence and policy transparency would also be helpful. Countries that pursue alternative policy approaches because of dollarization or specific trading patterns need to take special care to maintain sufficient robustness and flexibility in fiscal and structural policies.

**Accelerating financial sector reforms.** Latin America still lags behind other regions in financial intermediation and credit availability. Real interest rates remain high in many countries, reflecting, among other things, inefficiencies in the banking system and, in some cases, the taxation of banking transactions. Countries need to strengthen financial system regulation, build consolidated supervision, bring financial regulation up to international prudential standards, and upgrade bankruptcy laws. The continued development of local currency capital markets (including the deepening of local government and corporate bond markets, equity markets, and the introduction of derivative products, where appropriate) to manage interest rate and exchange rate risk would help improve the efficiency of financial intermediation. A strengthening of financial sectors would also help reduce the high level of dollarization that still characterizes some countries. Peru has shown that a combination of good macroeconomic policies and improved financial sector regulation can successfully reduce dollarization.

**Second, to raise low saving and investment ratios, and attract investors, policymakers should focus on:**

**Managing natural resources efficiently.** Despite having the largest proven oil reserves in the world after the Middle East, the region has been slow to take full advantage of the oil price
the success in diversifying exports, the U.S. market accounted
during the current expansion, and a more rapid growth of employment in the formal sector. The
to encourage labor to move from less productive to
more productive employment sectors. 

Improving the investment climate. Latin America generally
does less well than other, more rapidly growing regions in
providing the key ingredients of a friendly investment climate. Heavy regulation of the entry and exit of businesses, cumbersome labor force practices, and weak contract
enforcement divert domestic capital and investment overseas—often hitting hardest small- and medium-sized enterprises and those in rural areas. Business climates need to be
improved to encourage private investment, particularly by improving regulatory frameworks and strengthening competition policy. Governance also needs to be better; corruption and weaknesses in the rule of law undercut investor confidence in the enforceability of contracts and property rights.

Reforming labor markets. Labor market reforms—
notably absent for most Latin American countries in the
1990s—will, over time, yield broad-based benefits, including more rapid growth of employment in the formal sector. The state should provide safety nets to deal with transitional problems associated with intersectoral mobility, and invest in workers’ training and skill upgrading. Such reforms assume greater significance in the context of increased trade liberalization to encourage labor to move from less productive to more productive employment sectors.

Liberalizing and diversifying trade. Notwithstanding recent gains, Latin America is still relatively closed to international trade compared with other dynamic regions, contrasting sharply with the openness in the capital account. Trade initiatives—including the Central American Free Trade Agreement (see “Building on CAFTA” on page 30)—may help, and a successful and ambitious conclusion to the Doha Round also could provide a significant boost. Despite the success in diversifying exports, the U.S. market accounted for over 40 percent of the increase in the region’s exports between 2002 and 2004. Thus, robust growth in the United States, and continued access to U.S. markets, will be necessary to sustain healthy export performance, especially for countries with strong U.S. trade ties, such as Mexico.

Fulfilling its potential
Latin America’s recent resurgence amid continuing favorable external conditions provides another historic opportunity for the region to catalyze its considerable natural and human capital resources into sustained and higher growth. Latin America’s potential has never been in doubt—it has achieved several stretches of rapid growth in recent decades—but all too often, policy inconsistencies have precipitated debt and financial crises. With more consistent policies, the region could have sustained growth rates in the order of those found among the more rapidly growing emerging market countries in Asia.

The crucial challenge now for the region is to build on its recent resurgence, minimize the policy swings and uncertainties that have undercut previous growth episodes, entrench the forces generating the current growth momentum, and deepen structural reforms—especially those related to institutional strengthening and the labor market—that will limit harmful discretion, reduce rigidities, and open up new avenues for private investment and entrepreneurship. Much greater macroeconomic stability would contribute to the consolidation of robust democracies, providing a suitable backdrop for the many elections that lie ahead.

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OF VIEW

A Fork in the Road

Latin America faces a choice between populism and deeper reform

Arminio Fraga

On the surface, the IMF’s recent growth numbers for Latin America are quite encouraging: almost 4.8 percent average growth for 2004–05, and a forecast of 3.8 percent for 2006. This is an impressive turnaround when measured against the 1.4 percent average for 1999–2003. But the news is not quite as good when measured against the more exuberant backdrop of world growth—estimated at 4.7 percent in 2004–05 and expected to remain at 4.3 percent in 2006. Moreover, if we look at 1997 through what is projected for 2006, Latin America will have grown at 2.8 percent while world growth will have averaged 3.9 percent, split between 2.7 percent for the advanced economies and 5.3 percent for the emerging and developing countries. This lack of convergence in incomes relative to the advanced economies is quite disturbing, as is the underperformance relative to other developing countries, especially in Asia. What is the matter with Latin America? Why has growth lagged other emerging regions by so much? Have we seen progress in recent years? And are we heading in the right direction?

The lost decade(s)

To gain insight into these issues, it pays to begin with a review of the 1980s and 1990s. The 1980s became known in Latin America as the “lost decade” because per capita output growth averaged a shocking negative 0.6 percent a year, after the outstanding 3.8 percent performance of the 1970s (as measured by the GDP-weighted average of the seven largest economies in the region). This decade was marked by economic chaos in most countries in the region, and included multiple episodes of hyperinflation, international debt default, and deep recessions.

All over the region, nonorthodox approaches to macroeconomic stabilization were tried with tragic results. Brazil, for instance, struggled for years with a series of unconventional plans to curb inflation, each one failing as they did not address basic matters such as loose fiscal and monetary policies. Price freezes, asset freezes, and exchange rate pegs of all kinds were attempted in quick succession.

As the 1980s came to an end, it became clear throughout Latin America that certain basic elements of sound economic management had to be present to create an economic background conducive to growth and development. These elements, which became part of the so-called Washington Consensus, included fiscal discipline, a competitive exchange rate, and trade and foreign investment liberalization.

Over the following decade, most nations in the region managed to get their inflation rate down and make progress with avoiding banking and balance of payments crises. According to an index developed by Goldstein, Kaminsky, and Reinhart (2000), the number of crises in the seven largest countries in the region declined from 26 in the 1980s to 9 in the 1990s. Not surprisingly, growth in output per capita in these countries climbed to an annual average of 1.7 percent—a major gain relative to the 1980s—but below the 2.0 percent achieved by the United States and way below developing countries in other regions.

Progress on the macroeconomic front was matched by significant improvement on the social front. With the exception of school enrollment, indicators ranging from illiteracy to infant mortality displayed significant improvement, even during the years of the lost decade. Illiteracy dropped from 15.6 percent in 1980 to 7.9 percent in 2000, with primary school enrollment increasing from 85.2 percent to 95.4 percent. Life expectancy at birth improved from 66.1 percent to 72.1 percent, while the infant mortality rate dropped from 50.1 percent to 22.6 percent.

Similar gains were made on structural issues. A structural reforms index developed by Eduardo Lora of the Inter-American Development Bank shows that reforms increased from an average regional level of 318 in 1985 to 583 in 1999 (out of a maximum possible score of 1,000). More important, gains were recorded in total factor productivity (TFP). Using a measure that captures investments in education (and thus is lower than the usual labor productivity numbers, but offers a better measure of the true gains), TFP advanced from a shocking negative 2.28 percent a year in the 1980s to a modest but positive 0.33 percent a year in the 1990s (Fraga, 2004). Notice that here the regional average is misleading, as Colombia and Venezuela experienced declines of around 2 percent a year while Argentina and Chile showed gains of a similar magnitude.
Still, despite the major macroeconomic and social gains obtained in the 1990s, and with the notable exception of Chile, many in Latin America still felt like another decade had been lost, probably because the old ways of fast growth remained elusive. Oddly, some observers in the region "blamed" the Washington Consensus for the modest performance.

**Don’t blame the Washington Consensus**

My conclusion is different. While the number of crises did decline in the 1990s, most countries in the region failed to implement the main aspects of the Consensus and, as a result, failed to credibly consolidate macroeconomic stability. Take, for example, the high sovereign spreads and low credit ratings that prevailed in most countries in Latin America during the 1990s, especially when compared to Asia.

“**The best strategy for the new governments in Brazil and Mexico will be to aggressively push for structural reforms early in their terms, when the momentum of a successful election may carry the day.**”

I would argue that significant progress was achieved in Latin America in the 1990s, especially when compared to the mediocre 1980s. Moreover, the countries that followed the general lines of the Washington Consensus have done better than those that did not. Chile, the star performer, had both the best macroeconomic performance and the best and earliest record in implementing structural reforms. Mexico did well after 1995 on both counts and has achieved reasonable growth since then. Brazil has done well in many ways since 1994, but was unable to avoid two deep confidence crises (in 1999 and 2003), and is now involved in another political crisis. Argentina did shine on the structural reform front in the 1990s, but failed to secure macroeconomic stability and plunged into a deep recession in 2001.

**Elections could be decisive**

There is, however, a deeper issue underlying Latin America’s modest performance since the 1980s: Why have most of these nations failed to get their economic act together in a steady and convincing way? Why have they been unable to avoid frequent crises? And why have they been unable to save and invest more and better? These questions go way beyond economics, and I can only make some conjectures.

Currently, the macroeconomic fundamentals in the region look quite good. Sovereign spreads are very low, and inflation is low in most countries. But, as we know all too well, these reasonably sound fundamentals cannot be taken for granted. Over the next year, elections will take place all over Latin America. And there is a smell of populism in the air in many parts of the region that should not be ignored. A big question is whether Brazil and Mexico, the two largest economies, will follow the successful path of Chile or succumb to populist temptations, be they of the mild Argentine variety (price controls, regulatory uncertainty), or of the more extreme Venezuelan kind that puts democracy at risk as it aspires to the Bolivarian dream of uniting Latin America.

My view here is cautiously optimistic. Argentina and Venezuela are growing fast because they are recovering from deep recessions and are benefiting from fast global growth and vastly improved terms of trade (especially Venezuela). But despite this impressive economic rebound, these countries have yet to inspire confidence in the sustainability of their long-term growth paths.

In contrast, Brazil and Mexico appear to have managed to break away from the vicious cycle of economic crises and populism, each in their own way. In Mexico, the Fox government has refrained from revisiting the electoral tactics that led to a number of crises in the past. Moreover, initial moves by the main potential candidates seem to indicate no break in Mexico’s commitment to sound macroeconomic management. In Brazil, while the Lula government has not made progress in several key areas, macroeconomic policies have remained under strict control and are likely to stay that way throughout what is likely to be a hot political campaign in 2006. These are signs of maturity.

However, renewed worries arise when one thinks about the visible difficulties both countries are having in gathering political support for the structural reforms that are still needed. Here we move to the realm of the political economy, where the challenges are related to entrenched special interests, corruption, and poor electoral rules and incentives. These countries have to deal with the vicissitudes of their own political system and history, and in both cases, a consensus for reform has proven hard to reach—perhaps indicating the need for political reform ahead of other reforms.

Herein lies a challenge. Without political reform, structural reforms are unlikely to be enacted. Without reforms, growth is less likely to take off. Without growth, political support for macroeconomic stability will weaken, and the danger of a return to the ups and downs of the past cannot be ruled out.

What then? My guess is that the best strategy for the new governments in Brazil and Mexico will be to aggressively push for structural reforms early in their terms, when the momentum of a successful election may carry the day. Assuming this jumpstarts some growth, other reforms may become feasible. Not easy, but it can be done. ■

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The U.S. National Intelligence Council, in its “Mapping the Global Future”—a widely cited study on global trends shaping the world of 2020—concludes that the 21st century will be the Asian Century, with the rise of India and China as world powers. The report, which drew on the advice of over 1,000 experts on three continents, barely makes mention of Latin America. Outside of Canada and the United States, and occasional references to Brazil as a rising economic power, the countries of the Western Hemisphere south of the Rio Grande appear once again to have been sidelined by the dramatic changes of an increasingly globalized world. In addition, many observers argue that Latin American democracies are weak and unresponsive and that economic reforms have failed to generate substantial growth or reduce glaring income inequalities—the highest of any continent.

In my view, this portrait of the state of Latin America is overly pessimistic and downplays significant progress in the past quarter of a century. Until the 1980s, most countries in the region were governed by repressive authoritarian regimes that were incapable of implementing the far-reaching economic and political reforms they promised when seizing power at a time of political polarization and open conflict. Central America was in the throes of civil wars, while Colombia was racked by the growing power of international drug cartels that operated with impunity while drawing armed insurgents into the business. Unresolved border disputes threatened international peace, and standards of living declined in the wake of the international debt crisis.

The poor performance of authoritarian regimes and the end of the Cold War help explain the dramatic shift toward civilian elected governments. From 1930 until 1980, 40 percent of all governmental changes in Latin America were by military coups. That number dropped by half in the 1980s and disappeared after 1991, when the last classic military coup took place in Haiti. Historic democracies such as Chile and Uruguay returned to civilian rule, and countries with weak or no democratic traditions—such as Bolivia, Paraguay, and most of the countries of Central America—experienced for the first time successive transfers of power that followed constitutional precepts. Mexico, which had established a long-lasting one-party state, became a competitive multiparty democracy.

The mistake that many observers made was to assume that the establishment of democracy meant the swift consolidation of democratic institutions and procedures. As the North American and European experience has shown, the process of democratic consolidation is a long and difficult one that requires the strengthening of the formal institutions of governance and the rule of law, as well as the development of representative organizations such as political parties, which constitute an essential bridge between citizens and policymaking bodies.
Fragile democracies

The weakness of democracy in Latin America is evidenced by the fact that since the current phase of democratic governance began in the early 1980s, 14 elected presidents have not been able to finish their constitutional terms of office. Although the circumstances of their departures vary—including impeachment for corruption, the shortening of terms in office in the wake of electoral fraud, and social unrest accompanying the implementation of austerity policies—all of the heads of state were weakened by flagging support and the lack of majorities in parliament, making it impossible for them to govern. The personalization of government in presidential systems make chief executives particularly vulnerable. Citizens look to the president to solve the country’s problems, and when he fails to deliver, his removal from office is seen as an imperative. And yet, even in fragile democracies, such as Bolivia, presidential resignations have not so far led to a full breakdown of constitutional order, permitting political actors to manage the crises of democracy within a democratic environment, an essential part of the learning curve that actually strengthens pluralism.

Democratic consolidation requires that the challenges of building state capacity, accountability, representation, and governance are addressed. State capacity refers to the need to strengthen the institutions of governance themselves, both in their ability to deliver state services and in their capacity to enforce rules and regulations and maintain public order. Accountability implies the full implementation of the rule of law with transparent standards that apply to all regardless of status. Representation involves the fundamental fairness and efficacy of electoral systems and the strength of political parties as instruments for conveying citizen preferences. Governance refers to the ability of a nation’s formal powers embodied in the executive and legislative branches to translate diverse partisan preferences into effective policy options, either through majority rule or the establishment of viable coalitions.

Generally, the problems of democratic consolidation have been most acute in Paraguay, the Andean region, and Haiti, where nine of the 14 presidents did not finish their terms of office. Venezuela, which, together with Colombia and Costa Rica, avoided authoritarian rule in the 1960s and 1970s, is the only country where there has been a significant reversal in democratic consolidation. By contrast, Mexico, the Southern Cone (including Brazil), and the nations of Central America and the Caribbean have done surprisingly well. Argentina—where two presidents left office before the end of their terms in the throes of serious economic crises—appears to have turned the corner. Any analysis of Latin America’s progress must underscore this sharp differentiation, where Chile’s performance has been exceptional.

Growth not matching expectations

The shift to democratic governance was accompanied by far-reaching macroeconomic stabilization and structural adjustment policies and an opening of protected economies to international trade. These reforms helped break the perverse cycle of “stagflation,” contributing to improvements in fiscal stability that have not been jeopardized despite the talk of a return to populism in the region. But economic performance has not met earlier expectations, as economic growth has stalled or produced uneven results that—with exceptions such as Chile—have not made a significant dent on poverty rates. This was due in part to external shocks, such as the effect of the Asian financial crisis and the collapse of the Argentine economy after the breakdown of its currency board regime.

But just as the assumption that the establishment of democracy itself would inexorably lead to democratic consolidation, the assumption that market opening reforms would automatically lead to rising standards of living has also proved partial and inadequate. The reforms associated with the Washington Consensus are necessary conditions for the improving economic performance, but not sufficient ones. The experience of Latin America over the past two decades suggests that improvements in state capacity, accountability, representation, and governance—or, more generally, the quality of institutions and the policymaking process—are important factors in achieving economic and social goals.

“It is not that prosperity permitted democracy to flourish. Rather, it is the reverse.”

Or to put it another way, it was not the economic reforms of the Pinochet regime (the so-called first generation reforms) alone that explain Chile’s ability to grow its economy while cutting poverty levels in half. Rather, it was the strength of its established political institutions—particularly high levels of transparency and acceptance of the rule of law, coupled with the ability of strong and disciplined parties able to forge enduring governing coalitions that generated and implemented public policies—that enabled the country to break the mold.

Thus, it is not that prosperity permitted democracy to flourish. Rather, it is the reverse—the quality of representative institutions, the rule of law, and democratic governance are important factors in creating the conditions for sustainable and equitable long-term growth. Latin America needs to address the severe challenges of poverty and inequality while becoming more competitive in a globalized economy. The strengthening and consolidation of democratic institutions and the rule of law is a vital part of that process. ■

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Reference:
fter going through bouts of crisis or economic slowdown in the late 1990s and early 2000s, Latin America now enjoys brighter economic prospects and an ongoing recovery. But poverty and income inequality remain stubbornly high and deep-rooted. While the region overall is on track to meet the Millennium Development Goals (MDGs) relating to human development—being ahead of other regions in terms of child mortality, access to safe water, and gender equity in education—it lags behind on achieving the poverty goal (together with sub-Saharan Africa). Indeed, the World Bank estimates that Latin America is at risk of falling short (by 1 percentage point) of meeting the MDG of halving the 1990 level of poverty by 2015.

Exactly how big is the poverty problem? How come more progress has not been made? And what can be done to turn the situation around? This article explores these questions, suggesting that the key to reducing poverty in Latin America, a region of half a billion people, is to create a level playing field—providing the poor with the opportunities to improve their living standards through access to education, health, infrastructure, and financial services. Improving the access of the poor to assets and services will help them share in, and contribute to, economic growth.

A snapshot of the problem

Poverty measurement is a challenge for analysts and policymakers. International organizations use purchasing power parity (or PPP) figures, as these facilitate international comparisons. Using a level of $1 PPP a day, the World Bank estimates that extreme poverty in the region declined from 11.3 percent in 1990 to 9.5 percent in 2001—although,
because of population growth, the number of people living on $1 a day stayed at 50 million during that period (see table). For more recent years, preliminary estimates show a slight increase in the poverty rate. But based on a benchmark of $2 PPP a day, the region has not made much of a dent in poverty. The World Bank estimates that poverty has held at around 25 percent of the population since the mid-1990s. And because of population growth, the number of poor actually increased to around 128 million in the early 2000s.

Yet analysts and regional organizations frequently quote poverty levels in Latin America and the Caribbean that are much higher. That is because countries adopt their own national poverty lines to take account of both domestic economic and social conditions and their own standard of well-being. These national lines are not strictly comparable across countries, but they do enable governments to track progress and determine the number of people who could potentially benefit from poverty alleviation policies according to country-specific living standards.

Using national poverty lines (based on data from the Socio-Economic Database for Latin America and the Caribbean), poverty affects 39 percent of Latin Americans, meaning that more than 200 million lack incomes sufficient to cover basic food and nonfood expenditures. As for extreme poverty—which attempts to measure the inability to pay for a food basket of minimum caloric intake—the rate dropped slightly from 22.5 percent in the early 1990s to 18.6 percent in the early 2000s, with the actual number of people living in extreme poverty now standing at around 96 million.

Moreover, the regional averages hide considerable differences in the levels and trends among countries. For example, according to national poverty data, the poverty rate ranges from above 60 percent in Bolivia and Honduras to below 30 percent in Chile and Uruguay. Moreover, even within countries, these rates vary significantly, especially along ethnic lines (see “Latin America’s Indigenous Peoples” on page 23). In Mexico, recent data show that 90 percent of the indigenous population live below the national poverty line compared to 47 percent for the non-indigenous population. In Guatemala, these figures are 74 percent and 38 percent, respectively. And in Brazil, poverty among the Afro-descendants is 41 percent compared to 17 percent among the whites.

### Accounting for the high poverty rate

Why has poverty remained so high? First, economic growth has been insufficient. It is well documented that sustained poverty reduction is closely associated with economic growth, but the region achieved a lukewarm 1 percent per capita growth rate over the past 15 years. Moreover, the responsiveness of the incomes of the poor to that growth (known as poverty-growth elasticity) can vary greatly. One factor that feeds into the degree of responsiveness is the level of inequality, and in the case of Latin America, inequality of incomes is extremely high (see Chart 1). As a result, on average, each 1 percent of growth in the region translates into just 1 percentage point fall in poverty—and for the region as a whole over the past 15 years, growth has barely averaged above 1 percent annually.

Second, the growth that has occurred during this period has not generally been pro-poor. As Chart 2 shows, for many countries, such as Paraguay and Argentina, since the mid-1990s per capita income for the poorest 40 percent fell, not rose. In those countries in which per capita incomes for the poorest rose, the increase was less than for the average population as a whole. Only in a handful of cases—Chile, Nicaragua, and Peru—was the increase in the incomes of the poor significantly above the national average growth.

Third, although macroeconomic stability in the region over the past 15 years has generally improved, the succession of economic crises, particularly in the late 1990s and early 2000s, proved devastating for the poor. For example, the poverty rate shot up from 30.8 percent to 58.0 percent in Argentina between 1999 and 2002, and from 26.6 percent to 42.2 percent...
in the Dominican Republic between 2002 and 2004. Indeed, several studies have shown that economic crises in the region since the mid-1980s have ratcheted up poverty rates even after economic recovery from the crisis has taken hold.

Fourth, the poor lack the minimum level of assets to fully benefit from the growth process. This includes deficiencies in the level and quality of education and health, as well as in access to basic social services and infrastructure, such as paved roads, reliable electricity, clean water, and sewerage. They also face unequal opportunities in access to credit, justice, risk management, and property rights. And the poor often face lower returns to their endowments and productive activities because of their place of residence or plain discrimination.

Finally, we have more evidence now that deep poverty and inequalities of opportunity can also undercut growth, as argued in the World Bank’s World Development Report 2006 (see “The Inequality Trap” on page 34 of this issue) and a forthcoming World Bank report on Latin America. Thus inequalities of opportunity not only prevent Latin America’s poor from benefiting from growth but can also lower economic prosperity for the region’s population as a whole. Inequality of opportunity matters the most for development policy because it is amenable to effective public policy intervention.

**Providing opportunities**

So what can policymakers do to turn the situation around? A vital component of any poverty reduction plan will include addressing the constraints that the poor face in accessing assets and services, so that they can secure better jobs and boost productivity. A key way to do this is through concerted actions in social policy and the growth and competitiveness agendas of most countries. But additional efforts are needed to ensure that the poor benefit at least as much as the rest of the population from actions on these fronts. This is, however, a multifaceted challenge. In some cases, the poor will benefit the most from targeted programs such as means-tested conditional cash transfers, urban development of slums, or rural infrastructure programs. In other cases, the provision of services need reform to ensure that the poor are well served (assuring similar quality of education, or promoting financial expansion). The good news is that there are a number of promising avenues under way in the region.

**Building human capital with smart transfers.** Human capital (encompassing the level of education, health, and nutrition of the population) is quintessential for enhancing the productivity of Latin America’s poor. Recently several countries have successfully pursued a new generation of cash transfer programs. In previous decades, there was a lot of skepticism about the potential role of cash transfer programs as poverty alleviation mechanisms, because they were seen largely as short-run remedies that were difficult to target effectively and ran the risk of being appropriated for political purposes. The new wave of social assistance makes cash transfers conditional on the beneficiaries sending their children to school and receiving basic maternal and infant health care. As a result of strong positive impacts from rigorous evaluations in Brazil, Colombia, Honduras, Mexico, and Nicaragua conditional cash transfers are now regarded as important components of a long-term poverty reduction strategy. These programs are well targeted, and while their impact on primary enrollment is small where levels are already high, they have had a large impact on delaying dropout and improving transition rates and secondary enrollment (especially for girls). Overall, the average impact on the grade attained at school is up by between 0.6 to 1.4 years (see Chart 3).

However, the coverage of these programs remains relatively small, and they are by no means substitutes for well-designed measures to improve overall access and the quality of educational, health care, and child nutrition services.

**Access to financial services.** In Latin America, many populist financial policies that were launched in the name of the poor have failed. Unfortunate examples are subsidized credit and direct state lending—policies that almost always ended up favoring the better off. Countries have also tried microcredit, but even where it has been successful, it constitutes a very small fraction of credit to the private sector. In fact, informal
finance institutions such as rotating savings and credit associations are often less efficient than well-developed credit markets (Besley, Coate, and Loury, 1994). In that sense, expanding financial services to the poor requires broadening the reach of formal financial institutions by improving the banking sector’s infrastructure for financial intermediation and developing approaches that encourage banks to offer affordable financial products to poor households.

**Access to infrastructure.** Another promising initiative—although it awaits rigorous impact evaluation—is the territorial approach to infrastructure provision, where assets and services may be provided exploiting local knowledge, local economies of scale, and complementary development projects. In urban areas, programs like the *Favela Bairro* in Brazil show that it is possible to turn urban slums around and capitalize the investments made by their inhabitants. A comprehensive program to improve physical infrastructure and public services, education, and commerce, and provide income-generating activities has helped boost both living conditions and the local economy. In rural areas, community-driven development efforts facilitated the efficient delivery of basic infrastructure and services, including rural roads, electricity, and potable water, in conjunction with credit and technical assistance. The flagship example is the community-driven development projects in northeast Brazil, where communities prioritize, manage, and monitor investments through participatory municipal councils. A key element of success is having an integrated vision of subnational development based on local knowledge.

**Translating opportunities into incomes**

How can the equalization of opportunities be turned into higher incomes and eventually a higher quality of life? The key is productive employment. And for that reason, moving out of poverty in a sustainable way will require generating good jobs and enabling the poor to access them. Over the past 15 years, employment in Latin America did rise, but most of the jobs were created in the informal sector. This may be partly the result of the growing number of women participating in the labor force and a shift toward jobs in the service sector. But ultimately, the size of the informal sector reflects decisions taken by firms and workers for whom the rational choice is to operate outside the regulatory framework. Their low productivity leaves them unable to pay taxes or make social security contributions.

To reverse this is an enormous challenge for the region. Part of the solution is an increase in productivity by leveling the playing field for the poor in terms of equality of opportunities. It also requires changes in tax and labor legislation, along with more efficient public services and a better quality and more inclusive social protection system. Ultimately, workers must be able to afford health and old-age risk protection.

How will a more inclusive social policy for the poor be financed? Countries choose how much they want to tax and redistribute. In Latin America, the implicit social contract in the current structure of taxes and transfers has failed to provide equal opportunities to vast segments of the population. With exceptions, taxation is low and distortionary and social transfers go disproportionately to the rich, either through public pensions, nonpreventive health care, or public tertiary education (De Ferranti and others, 2004). In many cases, an equilibrium of low taxes and low public expenditures is maintained because the rich and the middle class opt out. Health services, education, and social protection are paid directly by the rich, who do not have any interest in exerting political pressure to improve the quality of these services when they are provided by the government. The challenge for Latin America is to modify the social contract to make it more inclusive for both taxation and expenditure. This implies ensuring that the pattern of social expenditures in general is not biased against the poor.
Defining an effective strategy

Since poverty is multifaceted, countries will need to adopt policy interventions on multiple fronts, subject to scarce financial and political capital. This means that they will have to find a way of coordinating these various interventions, and the hope has been that this could be done through an integrated poverty reduction strategy (PRS). In recent years, many Latin American countries have tried this route, but the results are quite mixed.

The poorest countries (Bolivia, Guyana, Honduras, and Nicaragua) started implementing PRSs in early 2000 under the Heavily Indebted Poor Countries initiative. The idea was to link sector strategies to poverty reduction in an integrated manner, while monitoring progress to assess the effectiveness of the strategy. However, continuity and policy implementation have been weak, the participatory decision-making process has not always been regular, and poverty monitoring processes still have to be strengthened. As for the middle-income countries, several of them—including Colombia, Guatemala, Mexico, Paraguay, and Peru—have crafted PRSs or national development strategies. In some cases, these have been government-crafted strategy documents; in others, participatory processes were or are being tried. In most cases, the strategies have not been effective in prioritizing how to tackle the key constraints in the economy so that growth is translated more effectively into poverty reduction.

These experiences point to three main lessons in shaping the agenda for poverty reduction:

First, sustained growth is the cornerstone for poverty reduction, but it needs to be accompanied by integrated strategies that encompass economic and social policies to enable the poor to benefit and be part of the growth process. Most governments in poor- and middle-income countries are paying more attention to growth and to policies that facilitate and foster job creation—not relying only on social sector policies aimed at assisting the poor. Countries should recognize and act on poverty reduction being also part of the agenda for growth and competitiveness.

Second, any strategy must prioritize and define the appropriate and realistic set and sequence of policies, taking into account financial, administrative, and political constraints. A strategy must distinguish between “the essential and the merely desirable” (Grindle, 2004). It must establish a roadmap, a sequence, and transitional strategies, particularly when in the short run some segments may lose from needed reforms. So far national plans have, in many cases, been a comprehensive collection of well-intentioned policies and valid objectives, reflecting the fact that poverty reduction implies making progress on a multiplicity of fronts. But prioritization, although scientifically and politically complex, is essential. It implies identifying what set of reforms, and in what sequencing, is most effective at reducing poverty, given budget constraints and what is politically feasible. The challenge for each country is to establish a strategy that takes account of both the fiscal and human resources, as well as the political capital, required to pursue policy change.

Third, progress needs to be monitored and evaluated. Formal poverty reduction strategies in heavily indebted poor countries have included the implementation of monitoring and evaluation systems. At the project level, there is a growing interest in impact evaluation, and several countries (Brazil, Chile, Colombia, Mexico, and Peru) have made progress in implementing various aspects of integrated monitoring and evaluation systems. Such systems allow performance and financial indicators at the program and sector level to be monitored and fed into a centralized system that can be used in the budgetary allocation process. But progress in this area is uneven, and there is a long way to go before these systems and a results-oriented culture are institutionalized. The key point is that for resources to be spent in providing opportunities to the poor, the state has to facilitate accountability and needs to establish the mechanisms for a transparent and efficient monitoring of the use of public resources.

Thus, while poverty and inequality remain entrenched, it is becoming increasingly clear how progress can be made on improving living standards in Latin America. The huge disparities between the rich and poor should be tackled by providing the poor with a fair social and productive asset base—that is, leveling the playing field. This will allow them to move out of poverty, so long as they are able to access the opportunities in the labor market that will enable them to boost their incomes. And this will in turn improve economic prospects for all Latin Americans. Several avenues are proving to be effective. But in most cases, the biggest challenge will lie in defining and implementing the priorities of poverty reduction strategies, given the financial and political constraints.

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Latin America’s Indigenous Peoples

Gillette Hall and Harry Anthony Patrinos

IN DECEMBER 1994, the United Nations proclaimed 1995–2004 the International Decade of the World’s Indigenous Peoples. In Latin America—where indigenous peoples comprise some 10 percent of the population—the ensuing decade coincided with an upsurge of indigenous movements exercising political influence in new and increasingly powerful ways. In 1994, the Zapatista Rebellion took place in Chiapas, Mexico. In Ecuador, indigenous groups took to the streets five times, leading to negotiations with the government and, ultimately, constitutional change; similar demonstrations in Bolivia led to the fall of the Sanchez-Lozada government in 2003. In Guatemala, home to Nobel Prize winner Rigoberta Menchu—an indigenous Mayan—the country’s bitter civil war ended in 1996, with the Peace Accords that included an Agreement on the Identity and Rights of Indigenous Peoples. And Peru elected its first indigenous president, Alejandro Toledo, in 2000.

But palpable change on the economic front has been slower. In 1994, a World Bank report (Psacharopoulos and Patrinos) provided the first regional assessment of living standards among indigenous peoples, finding systematic evidence of socioeconomic conditions far worse than those of the population on average. Ten years later, a major World Bank follow-up study (Hall and Patrinos, 2005) found that while programs have been launched to improve access to health care and education, indigenous peoples still consistently account for the highest and “stickiest” poverty rates in the region. This slow progress poses a major hurdle for many countries trying to reach the UN Millennium Development Goal (MDG) of halving the 1990 poverty rate by 2015.

Who are the indigenous peoples of Latin America? While there is great diversity among groups, they share certain characteristics, such as distinct language (even if many no longer speak it fluently), culture, and attachment to land—all stemming from the fact that their ancestry can be traced to the original, pre-Colombian inhabitants of the region. Estimates for the number of indigenous people vary from 28 million to 43 million. In the five countries that have the largest indigenous populations—Bolivia, Ecuador, Guatemala, Mexico, and Peru—indigenous peoples represent a significant share of the population (in Bolivia, they are the majority). There are literally hundreds of different indigenous groups. In Mexico alone, there are 56 recognized indigenous groups and 62 living languages.

Despite greater political power, indigenous peoples still lag behind
**A yawning gap**

The World Bank’s 1994 report uncovered striking evidence of low human capital (education and health) as a driving force behind the high poverty rates, coupled with evidence of social exclusion via labor market discrimination and limited access to public education and health services. What does the picture look like now?

**Poverty.** For the five countries with the largest indigenous populations, poverty rates for indigenous peoples remained virtually stagnant over the past decade—or where rates did fall, they fell less on average than for the rest of the population (see chart). In the three cases where national poverty rates declined (Bolivia, Guatemala, and Mexico), the rate for indigenous peoples registered a smaller decline, or none at all. In Ecuador and Peru, overall poverty rates increased, but for the indigenous, there was little change. This pattern suggests that indigenous peoples may be less affected by macroeconomic trends, whether positive or negative—although evidence from Ecuador suggests that even if the negative impact of a crisis is small for indigenous households, it takes them longer to recover. The poverty gap (average difference between the incomes of the poor and the poverty line) among indigenous peoples is also deeper, and shrank more slowly over the decade, compared to the same indicators among non-indigenous populations.

**Education.** Education is one of the main factors that propel people out of poverty, yet indigenous peoples continue to have fewer years of education than non-indigenous ones. In Bolivia, non-indigenous children have 10 years of schooling versus 6 for indigenous; in Guatemala, the years are 6 versus 3. The good news is that in all countries the schooling gap shrank over the 1990s, following trends established in earlier decades. But the bad news is that the average increase in earnings as a result of each additional year of schooling (the private rate of return to each year of schooling) is slightly lower for the indigenous—in Bolivia, it is 9 percent for the non-indigenous and 6 percent for the indigenous. Moreover, the gap is widening at higher schooling levels. What is behind this failure? The culprit may well be the quality of education that indigenous people receive. Recent standardized tests in the region reveal that indigenous students achieve significantly lower scores—from 7 to 27 percent lower—on reading and math tests.

**Health.** Indigenous peoples, especially women and children, continue to have less access to basic health services. As a result, major differences in indigenous and non-indigenous health indicators persist, ranging from maternal mortality to in-hospital births and vaccination coverage. In all five countries, health insurance coverage remains relatively low, failing to surpass 50 percent of the population. In three of the five countries (Bolivia, Guatemala, and Mexico), coverage of indigenous families lags substantially behind the rest of the population. An important gap to emerge is that indigenous children continue to exhibit extremely high malnutrition rates, even in countries that have otherwise virtually eliminated this problem. In Mexico, just 6 percent of children nationwide are underweight compared with almost 20 percent of indigenous children.

**Labor.** Evidence that indigenous peoples face significant disadvantages in the labor market is strong across the region. In late 2004, the portion of the difference in earnings between indigenous and non-indigenous peoples that is “unexplained”—perhaps due to discrimination or other unidentified factors—represented one-quarter to over one-half of the total differential, with the average at about 42 percent. This means that while about half of the earnings differential can be influenced by improvements in human capital (education, skills, and abilities that an indigenous person brings to the labor market), another half may result from discriminatory labor market practices or other factors over which the indigenous person has little control.

**Starting to make headway**

Over the past decade, significant political and policy changes have occurred with potential bearing on poverty and human development outcomes among indigenous peoples. These changes range from constitutional mandates and greater political representation to increased social spending and a proliferation of differentiated programs, such as bilingual education. Yet while some improvements have occurred in human development outcomes, particularly in education, these changes have yet to bring about the desperately needed reductions in indigenous poverty because of poor education quality, poor health outcomes for children, and limited opportunities once today’s children reach the labor market. And although political representation of indigenous groups has increased in recent decades, they still cite lack of support from and a lack of voice in government as a substantive reason for their continued poverty.
Against that background, what shape should the future policy agenda take? Our results suggest that it must be broad enough to embrace issues such as land rights, labor legislation, and access to credit. On the human development front, we would suggest the following:

First, **more and better education.** Functional bilingual education programs are needed—including schools where teachers speak the same indigenous language as the students; teachers are prepared to teach in a bilingual classroom environment; and parents and the community participate in the design of curricular materials. Well-designed, well-implemented, and rigorously evaluated programs can produce significant returns. In Guatemala, indigenous students enrolled in bilingual schools tend to have higher attendance and promotion rates, and lower repetition and dropout rates. Bilingual education, despite the higher cost associated with teacher training and materials, may lead to cost savings through lower grade repetition and hence lower unit costs and more places generated for new students. In Guatemala in 1996, the cost savings were estimated at $5 million, equal to primary education for 100,000 students. Policymakers must also step up efforts to get all children in school, with incentives such as cash transfer programs. From 1997–99, Mexico’s cash transfer program—*Oportunidades* (formerly *Progra*)—resulted in higher school attainment among indigenous peoples and a significant reduction in the skills gap between indigenous and non-indigenous children.

Second, **better health.** Efforts need to be focused on the persistently high levels of malnutrition and associated high infant mortality rates, vulnerability to disease, and low schooling outcomes. Policies should promote equal opportunities for indigenous peoples—a sort of “head start”—including programs for maternal and child health and family planning. In some cases, it may be necessary to ensure that indigenous health practices that have proved effective be made available through national health systems. Ecuador, for example, is experimenting with combined services that offer a choice between modern and traditional medicine. It may also be necessary to train skilled providers in indigenous languages and cultural sensitivity.

Third, **better social service delivery.** The substantial progress in certain human capital inputs—such as quantity of school and health services—for indigenous peoples over the 1990s may not have led to a significant impact on earnings because of an insufficient voice in service delivery. Thus, there may be a need to explore strategies to strengthen the direct influence of beneficiaries on service providers. These could include enhancing client power or leverage of parents through choice or voice directly at the school level. Putting recipients at the center of service provision could also help by enabling them to monitor providers and amplify their voice in policymaking. Already, Mexico has been putting this idea into practice: the compensatory education program gives indigenous peoples a small but significant role in school management. Impact evaluations have shown this to be effective (Shapiro and Moreno, 2004).

In addition, better analysis of the conditions and needs of indigenous peoples, based on an improved data collection effort, would be essential. At present, there is no systematic way of accurately identifying indigenous peoples in census or household surveys. Thus, a list of standardized questions for surveys in different years and countries should be developed. It could include self-identification, language (mother tongue, commonly used language, language used at home, and secondary language), dominant group in the local community, and parents’ mother tongues. Statistical agencies should also include a special survey module to delve deeper into the causes of poverty and constraints faced by indigenous peoples, as well as opportunities. That module could study traditional medicine practice, religious and community activities, land ownership, and bilingual schooling.

* * * *

We hope that by building on the changes observed during the first indigenous peoples’ decade, the next decade will bring them greater gains—in terms of human development, material well-being, and culturally appropriate economic and social development. The first step lies in setting realistic goals in terms of poverty reduction and human development, starting with disaggregated information on the MDG indicators. This would facilitate monitoring during the decade, coinciding with the culmination of the MDG period in 2015. Along with targets, monitoring, and evaluation, indigenous peoples—not just the leaders but community members and families as well—should participate in realizing these important goals.

In his 1934 book, *Fire on the Andes*, journalist Carleton Beals wrote “the uncut umbilical cord of South America’s future is its duality, still the secret of political turmoil and national frustration. Until this duality is reconciled, [the region] can know no enduring peace, can achieve no real affirmation of its national life.” The fact that 70 years later a report must still be written about this very duality signals the great depth of the inequalities, and the great magnitude of the task ahead.

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How Latin America’s central banks survived hyperinflation to become guardians of price stability

Agustín Carstens and Luis I. Jácome H.

In 1990, average inflation in Latin America reached an unprecedented 500 percent. Argentina, Brazil, and Peru—three of the region’s largest economies—posted four-digit rates of inflation, and no country managed to achieve inflation below 10 percent. As standards of living suffered, governments undertook far-reaching structural changes—including central bank reform—that eventually provided the underpinnings needed to wage a successful war on inflation.

Today, inflation has been brought down to single-digit territory in most countries in Latin America. Central banks have played a key role in achieving this turnaround, but they still need to address at least three important challenges. First, most central banks have yet to achieve price stability. Second, in a number of countries, central banks need to restore market confidence in domestic currencies. And third, central banks have to maintain policy consistency in the face of volatile capital flows. Recurrent banking crises and lax fiscal discipline may threaten their ability to meet these challenges.

Mapping central bank reform
Starting with Chile in 1989, almost all Latin American countries have approved legislation that grants central banks enhanced autonomy in return for greater accountability. These reforms pursue four goals, prioritized differently across countries:

- **A clear mandate** to pursue price stability rather than economic growth (which used to be the primary goal);
- **Political autonomy** to formulate monetary policy, which has had the effect of untying policymaking from electoral calendars;
- **Operational autonomy** to conduct monetary policy without restrictions, including the ability to set interest rates without government interference and strict limitations—sometimes even prohibitions—on financing fiscal deficits; and
- **Accountability** for achieving inflation targets.
These institutional changes have, in most countries, been complemented by a change of monetary policy regime. Over the past 10 years, most central banks migrated from exchange rate pegs to flexible arrangements. At the beginning of the 1990s, with inflation in the region hovering around triple digits, most countries embarked on stabilization strategies based on an exchange rate anchor supported by growing capital inflows. In practice, this meant that most central banks abdicated—or at least strongly restricted—their ability to conduct monetary policy. But a string of systemic financial crises, sometimes combined with excessively expansionary fiscal policies, eventually led to the collapse of exchange rate pegs in Argentina, Brazil, Ecuador, Mexico, Uruguay, and Venezuela.

The transition to exchange rate flexibility was traumatic and was accompanied by swift and steep devaluations. To restore a nominal anchor, central banks in Brazil, Chile, Colombia, Mexico, and Peru introduced inflation targeting in the late 1990s and early 2000s. The new legislation allowed central banks to formulate monetary policy with a clear objective, based on independent and transparent decision making, and subject to strict accountability requirements. Most central banks also seized on their newfound autonomy to modernize their operating procedures in an environment of flexible exchange rates. They shifted from the traditional method of controlling the money base as an intermediate target to using a short-term interest rate as the main lever of monetary policy. Today, a number of central banks signal the direction of their policies by changing short-term interest rates.

**The elusive quest for price stability**

The institutional reform of monetary policy, in conjunction with other macroeconomic and structural changes, has resulted in an impressive decline in inflation in Latin America (see box). But there is no room for complacency. While average inflation has declined to the single digits, it has not yet converged to world levels in most countries. This matters because inflation tends to restrict economic growth in the long run, thereby holding back badly needed improvements in living conditions. However, further cutting inflation may be a difficult endeavor because of its potential adverse impact on output in the short run. Whereas in the 1990s, Latin America supported anti-inflation policies as a vital social objective, today governments are focusing their efforts on spurring economic growth—after three decades of very modest improvements in per capita GDP.

In this environment, central banks should seek to achieve price stability while minimizing the potentially adverse effect of their policies on output. A key ingredient of such a strategy is to make central bank policies more transparent and predictable. This may help bring interest rates down, thereby encouraging investment and production. While central banks in the region—especially those that practice inflation targeting—have increased transparency, there is still room for improvement in many countries. Measuring the transparency of monetary policies by region, Latin America ranks...

**What independence does for you**

Does greater legal (de jure) central bank independence translate into lower inflation? As Chart 1 illustrates, there is a negative correlation among these two variables when considering periods before and after central bank reforms. A recent IMF study by Jácome and Vázquez (2005) on Latin America and the Caribbean shows that legal central bank independence, together with other macroeconomic variables, contributed to reducing inflation, although no causality is identified. The analysis controls for a broad index of structural reform (excluding monetary aspects) and external inflation.

However, the same relationship is not found with respect to fiscal deficits—contrary to conventional wisdom. This means that central bank reform did not encourage greater fiscal discipline in Latin America (although one needs to keep in mind that fiscal policy during this period was influenced by the banking crises that hit the region and the fiscal costs associated with these crises). It seems governments simply replaced central bank money with public debt to finance fiscal deficits.

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**Chart 1**

**Price buster**

Central bank independence has been helpful in reducing inflation in Latin America . . .

... but contrary to popular wisdom it has not had any discernible impact on fiscal deficits.

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behind Europe, Asia, and the Middle East and Central Asia (Carstens and Jácome, 2005). Central banks should also react consistently when faced with exogenous and policy-induced shocks and improve their ability to explain their policies for fighting inflation. Such steps will help market participants anticipate central bank reactions, thereby reducing uncertainty and making markets more inclined to align their inflation expectations with central bank targets.

Also, central banks’ de facto autonomy needs to be strengthened. At present, the high turnover that has marked the tenure of many central bank governors is a cause for concern. Following reforms, central bank governors in Latin America have on average stayed in office for about two and a half years—clearly less than their term of appointment, which is typically between four and six years. This turnover is also greater than in industrial countries, where central bank governors routinely complete their term and sometimes have it extended.

**Pesos rather than dollars**

Another challenge for most of Latin America’s central bankers is how to address widespread dollarization—the use of the dollar instead of the local currency. In many countries, dollarization was a way of coping with long periods of inflation and a lack of confidence in the local currency. But dollarization is now complicating the task of conducting monetary policy. It has also created vulnerabilities in financial systems and prevented an effective response to banking crises.

In particular, in some Latin American countries, a high level of financial dollarization (economic agents holding many of their assets and liabilities in dollars) has made central banks hesitant about floating the local currency because of the damaging effect a depreciation might inflict on unhedged market participants—known as “fear of floating” (Calvo and Reinhart, 2002). In addition, some central banks wrestle with the “peso problem”—a persistent lack of confidence in the local currency, which manifests itself by high real interest rates that reflect a premium imposed by the markets fearing the potential risk of a sudden exchange rate depreciation—even if such a risk is minimal.

Defeating dollarization will take time. While the institutional strengthening of monetary policy represents a major step in the right direction, central banks need to further boost their credibility by continuously meeting their inflation targets. But even this will not be enough. They will also need to create instruments to enhance the peso’s capacity to compete with the dollar and reinforce the prudential regulations that apply to foreign exchange operations and the exposure to exchange rate risks by financial intermediaries.

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**Coping with capital inflows**

On top of fighting residual inflation and the implications of dollarization, Latin America’s central banks face a third challenge: the recent surge in capital inflows has put pressure on the consistency of monetary policy. This is important because if markets are unable to anticipate and understand central bank decisions, the existing inflation bias will be perpetuated. As a result, efforts to reduce inflation will demand higher interest rates than otherwise, with a negative effect on output.

As capital inflows have soared in the past two years, domestic currencies have tended to appreciate, presenting central banks with the dilemma of whether to intervene in the foreign exchange market to avoid real appreciation. The current oil supply shock has further complicated central banks’ policy response by triggering a slight rebound in inflation in many countries. To cope with inflation pressures, central banks have raised interest rates, but these have attracted additional capital inflows, thereby exacerbating the appreciation trend of domestic currencies. In this environment, intervening in the exchange market helps preserve external competitiveness, but does not favor anti-inflation efforts. It also damages the consistency of monetary policy—leading to a loss of credibility for the central bank, and making for a less effective monetary policy. Alternatively, allowing exchange rate appreciation hurts the tradable sector of the economy even though it helps curb inflation and preserves policy consistency.

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**Chart 2**

**Counting the cost**

Banking crises have exerted a great toll on economic growth in many Latin American countries over the years.

<table>
<thead>
<tr>
<th>Country</th>
<th>Percent Real GDP Growth (left scale)</th>
<th>Percent Inflation Rate (right scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td><img src="chart2/Argentina.png" alt="GDP Graph" /></td>
<td><img src="chart2/Argentina.png" alt="Inflation Graph" /></td>
</tr>
<tr>
<td>Dominican Republic</td>
<td><img src="chart2/DominicanRepublic.png" alt="GDP Graph" /></td>
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</tr>
<tr>
<td>Ecuador</td>
<td><img src="chart2/Ecuador.png" alt="GDP Graph" /></td>
<td><img src="chart2/Ecuador.png" alt="Inflation Graph" /></td>
</tr>
<tr>
<td>Mexico</td>
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<tr>
<td>Uruguay</td>
<td><img src="chart2/Uruguay.png" alt="GDP Graph" /></td>
<td><img src="chart2/Uruguay.png" alt="Inflation Graph" /></td>
</tr>
<tr>
<td>Venezuela</td>
<td><img src="chart2/Venezuela.png" alt="GDP Graph" /></td>
<td><img src="chart2/Venezuela.png" alt="Inflation Graph" /></td>
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So what should be done? As a matter of principle, central banks should stick to price stability as their primary objective, and exchange rate interventions should be limited to curtailting excessive volatility in the foreign exchange market. To cope with the cost on tradable activities associated with the exchange rate appreciation, domestic producers should seek to improve productivity. Meanwhile, governments should deepen structural reforms to make their economies more flexible (including the labor market) and better able to withstand exogenous shocks.

**Guarding against crises**

The risk of recurrent banking crises and a lack of fiscal discipline is adding to the complexity of managing monetary policy. Banking crises are an all too common event in Latin America. Since 1990, banking crises have been the main cause of inflation reversals and economic contraction in many countries (see Chart 2). They have also resulted in a number of (often simultaneous) currency crises. From a macroeconomic perspective, many banking crises have left behind a legacy of weakened market discipline as a result of blanket guarantees and widespread debt restructuring. And in some cases, the confidence of bank customers suffered long-lasting damage as the maturities of their deposits were unilaterally reprogrammed.

Most countries in the region have made progress in establishing a framework for preventing and managing banking crises, but more needs to be done. The new reforms must emphasize prudential regulations and vigorous supervision. Experience shows that once a crisis erupts and escalates, the costs are inexorably high. Countries should, therefore, focus on improving early warning systems and, more important, empower bank regulators to effectively deal with incipient bank liquidity and solvency problems. In turn, the legal framework for bank restructuring and resolution should be improved to allow countries to manage and resolve banking crises in a cost-effective manner.

On the fiscal front, Latin American governments will need to keep deficits in check. After an initial period of fiscal consolidation during the early 1990s, fiscal deficits have grown again in a number of countries—in some cases in the aftermath of banking crises. Because financing public expenditure with central bank resources is already legally restricted, public debt is picking up again in various economies, thereby leading to increasing debt-to-GDP ratios. Rising debt may lead to a surge in real interest rates and “country risk” indicators, which will reduce the room for maneuver of monetary policy and exacerbate output-related costs of pursuing disinflation. If a deteriorating fiscal stance becomes unsustainable, it may result in a currency crisis, as it did in Brazil in 1999, or in a banking, currency, and sovereign debt crisis, as in Argentina in 2002.

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**Safeguarding Financial Stability: Theory and Practice**

*By Garry Schinasi*

How is finance related to economic processes, and why should it be viewed as a public good requiring policy action? This book provides an answer and also: i) develops a practical framework for safeguarding financial stability, which encompasses both prevention and resolution of problems, and ii) examines ongoing and future challenges to financial stability posed by “globalization,” a growing reliance on OTC derivatives and their markets, the capital-market activities of insurers and reinsurers, and more.

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Building on CAFTA

How the free trade pact can help foster Central America’s economic integration

Alfred Schipke

REGIONAL integration is gaining momentum across the globe. In addition to the well-known integration efforts in Europe, policymakers in Latin America and the Caribbean, Asia, Africa, and the Middle East are considering policies to foster integration and regional coordination. Of course, the scope and rationale for these initiatives differ widely. For smaller countries, such as those in Central America, regional integration is a strategy to maximize economies of scale so that they can participate successfully in a more globalized economy.

Efforts to foster Central American integration started in the early 1960s. The region appears to be a natural candidate for integration because the countries share many of the same characteristics and enjoy a common history and language. At that time, the objective was to create a common market similar to the European model. But this process was interrupted by a period of armed conflict in parts of Central America.

Renewed political and economic stability from the 1990s onward has not only led to a resumption of economic growth and overall macroeconomic stability but also increased integration efforts both among the Central American economies and between Central America and the United States. Integration is taking place against the backdrop of a broadly shared commitment to economic growth, stability, and reducing poverty. However, poverty is still widespread, with about 50 percent of the population living in poverty or even extreme poverty, except in Costa Rica.
Rica (see Chart 1). The countries also remain vulnerable to economic shocks, and the political process is still fragile in some countries.

While the implementation of a clear reform agenda is often hampered by fragmented and sometimes highly polarized political landscapes, minority governments, entrenched interest groups, short election cycles, and governance problems, there is a growing consensus in favor of more integration and regional cooperation to ensure that the region takes full advantage of its potential. The implementation of the free trade agreement of Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua), the Dominican Republic, and the United States—referred to as CAFTA or CAFTA-DR—is expected to provide an additional boost to Central America’s global and regional integration and to serve as an anchor for further economic and institutional development. This article examines the progress to date and where the region is heading.

**Progress so far**

Central America’s integration has been advancing on two fronts. Economic ties with the United States have strengthened over the past decade, especially in trade, with exports to the United States now accounting, on average, for 80 percent of Central America’s total exports and 15 percent of GDP (see Chart 2). But strong and growing linkages are not limited to trade. For example, remittances of the large Central American community living in the United States are sizable and have increased rapidly over the past couple of years, amounting to 10–15 percent of GDP in 2004.

At the same time, integration among the Central American economies has also advanced. While intraregional trade continues to be limited—despite the elimination of most taxes on such trade and the establishment of a common external tariff—the region’s financial systems have become highly integrated. Local financial institutions that originally focused on the home market are increasingly providing services throughout Central America, and region-based institutions account for 30 percent of total bank assets (see Chart 3). Despite these developments, policy coordination at the regional level is still in its infancy, and the respective countries continue to pursue independent fiscal, monetary, and exchange rate policies.

But a number of regional institutions involved in information sharing and the harmonization of regulations are now taking the first steps toward coordinating policies. For example, the Central American Monetary Council provides a forum for the region’s central bank presidents to exchange information on monetary policy developments and risks to financial systems. The Central American Council of Financial Sector Superintendents has become a forum for financial sector superintendents searching for ways to reduce the risks associated with cross-border financial transactions, including the sharing of information and the adoption of common financial frameworks.

Other important regional institutions are the Central American Bank for Economic Integration, which finances, among other things, regional infrastructure projects; and the Secretariat for Central American Economic Integration (SIECA), which has played a key coordination role in the negotiations of CAFTA-DR. In the negotiations for the free trade agreement, Central America for the first time negotiated as a group. SIECA is also playing an important role in the negotiations of a free trade agreement with the European Union and in the planned creation of a Central American Customs Union.

**How will CAFTA impact integration?**

The CAFTA-DR free trade agreement is modeled after similar U.S. free trade agreements with Chile and Singapore, and the United States is currently negotiating similar bilateral agreements with Colombia, Ecuador, Panama, and Peru. Although the region already has preferential access to the U.S. market under the Caribbean Basin Initiative, CAFTA-DR will make this access permanent, providing greater predictability for both domestic and foreign investors. In addition, CAFTA-DR provides enhanced market access to the United States, including reduced local content requirements. And it goes substantially beyond trade to include...
investment flows, financial and government services, and provisions that will strengthen the institutional framework in the region, including property rights.

Trade agreements similar to CAFTA-DR are relatively recent and, therefore, empirical evidence to analyze the impact of such agreements is scant. Nevertheless, Mexico’s experience under the North American Free Trade Agreement (NAFTA) suggests that CAFTA-DR will provide a boost to trade and foreign direct investment flows, which, in turn, should spur economic growth (see Chart 4). Estimates by Hilaire and Yang (2003) suggest that output could increase by 1.5 percent as a result of the agreement. While the impact will vary by country, it could be substantially larger owing to various dynamic effects associated with the accumulation of capital, changes in specialization patterns, and stronger productivity spillovers.

The agreement will solidify regional economic ties with the United States and also foster integration among the Central American economies themselves. Furthermore, the expected impact of CAFTA-DR on trade and financial linkages between Central America and the United States suggests that their business cycles will become more synchronized. This is expected to reduce the overall macroeconomic volatility in the region, given the relative stability of the United States. As Mexico found with NAFTA, CAFTA-DR could further reduce volatility by accelerating the diversification of the export base and by fostering intra-industry and vertical trade linkages with the United States. Faced with more common shocks, the synchronization in business cycles will facilitate the coordination of macroeconomic policies in the region, allow for the adoption of similar policy responses, and contribute to the region’s integration efforts. In addition, the adoption of standards that in some cases mirror those in the United States will facilitate the harmonization of standards within the region.

Whether the expected impact of CAFTA-DR will actually materialize, however, depends crucially on whether complementary policies, including measures to foster labor mobility, improve the investment climate, and help address the negative effects that some groups could face during the transition period, are also implemented.

**Need for more policy coordination?**

Without appropriate regulation, supervision, and (in certain areas) policy coordination, the benefits of integration could be limited. In the case of Central America, more coordination may be needed in areas such as taxes, the financial sector, and exchange rate policy.

**Tax coordination.** CAFTA-DR makes the need for tax coordination in Central America more urgent. In the absence of such coordination, harmful tax competition could lead to a “race to the bottom.” Countries may lower tax rates or concede unnecessary tax privileges to attract foreign direct investment, eroding the already low revenue-to-GDP ratios, which average 13 percent of GDP (see Chart 5). In particular, the adoption of a “code of conduct” could help avoid a further reduction in corporate tax revenue. With increased regional integration, other areas of tax policy and administration might also benefit from increased coordination, including strengthening the base of corporate profit taxes (beyond streamlining of tax incentives and exemptions) by introducing a coordinated treatment of transfer pricing, concealed profit distribution, accounting standards, and a minimum income tax. There might also be scope for coordinating consumption taxes, including value-added tax, excises, and taxes and subsidies on petroleum derivatives.

**Financial sector.** Increased policy coordination and harmonization is also warranted in the financial sector. Financial integration in Central America is a positive development because it improves access to financial services, reduces funding costs, and allows for the diversification of risks across markets. This in turn should help spur economic growth. However, cross-border financial sector integration raises new challenges for regulation and supervision. In particular, there is a need to guard against regulatory arbitrage—that is, efforts by institutions to exploit differences

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and loopholes in regulations across regions—and the transfer of risks to less supervised areas. For example, differences in capital adequacy ratios could provide incentives for financial institutions to move operations to the country with the weakest prudential requirements.

In addition to the convergence of adequacy ratios, Central America needs a comprehensive framework for effective consolidated supervision of regional conglomerates. Supervisors need to work together in overseeing cross-border institutions and transactions, and the principle of consolidated supervision should be implemented rigorously and consistently across the region.

Exchange rate arrangements. Currently, the exchange rate systems in Central America cover the entire spectrum from official dollarization (El Salvador and Panama) to crawling pegs (Cost Rica, Honduras, and Nicaragua) to independent floats (Guatemala and the Dominican Republic). As the region continues to pursue sound macroeconomic policies, strengthen its institutions, and integrate further, the question arises whether the Central American economies should reevaluate their long-run exchange rate options. Apart from maintaining the status quo, the region might consider moving toward increased flexibility and inflation targeting, adopting a common currency (either independently floating or pegged), or full dollarization.

Using an optimal currency area index, which provides a summary measure of the relative suitability of different exchange rate systems, Central America has become more suited for a dollar peg or dollarization, reflecting increased synchronization of business cycles and a reduction in inflation differentials with the United States between 1993 and 2003 (see Chart 6). However, even after taking into account the expected impact of further CAFTA-DR–related integration with the United States, Central America is still less suitable for a common currency than Western Europe was in the 1970s. As the European experience has shown, the choice of a common approach requires full commitment at the political level.

Moving forward

The surge in regional or bilateral trade arrangements is in part a reflection of the slow progress of negotiations at the multilateral level. Completion of the Doha trade round is still the most important vehicle for promoting strong global growth and sustained poverty reduction. However, Central America is well positioned to benefit from further regional integration.

CAFTA-DR is expected to provide a further boost to this integration process, both with respect to the United States and within the region. But to ensure the greatest benefits possible, while minimizing the risks of increased vulnerabilities, the integration process calls for enhanced policy coordination and harmonization, especially in the area of taxes and in the financial sector.


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The Inequality TRAP

Why equity must be central to development policy

Francisco H.G. Ferreira and Michael Walton

A GIRL born to a lower-caste family of nine in the slums of Dhaka has vastly different opportunities from a boy born to well-educated and affluent parents in the well-heeled neighborhoods. An AIDS orphan in rural Zimbabwe is almost certain to have fewer chances and choices in life than a compatriot born to healthy and well-educated parents in Harare. Those differences are even greater across borders: an average Swiss, American, or Japanese child born at the same instant as one in a poor, rural area of South Africa will have incomparably superior life chances.

Such staggering inequalities in opportunity are intrinsically objectionable, and almost every culture, religion, and philosophical tradition has developed arguments and beliefs that place great value on equity for its own sake. But that is not all. We would argue—as elaborated in the World Bank’s World Development Report 2006: Equity and Development—that there is now considerable evidence that equity is also instrumental to the pursuit of long-term prosperity for society as a whole.

In developing this position, we do not focus on inequalities of outcomes (such as incomes), but on a conception of equity in terms of equality of opportunity. A person’s life prospects should not be influenced by circumstances outside his or her control—such as country of birth, gender, race, and family origins. Outcomes, by contrast, may well differ, as a consequence of differences in effort, talent, and luck. This approach draws on central trends in philosophy of the past few decades, notably in the work of John Rawls, Ronald Dworkin, Amartya Sen, and John Roemer. But we also recognize that societies may decide to intervene to protect the livelihoods of its neediest members (living below some absolute threshold of need) even if the equal opportunity principle has been upheld. For that reason, we include avoidance of absolute deprivation as a basic principle of equity.

Immense inequities persist

The shaping of opportunities begins before individuals are born. Who one’s parents are, what country they live in, and how rich they are, make a large difference to a person’s opportunities in terms of life expectancy, education, access to services, and economic prospects. As Chart 1 shows, infant mortality rates vary markedly both within and across countries. In El Salvador, for instance, babies born to mothers with no schooling are four times more likely to die before their first birthday than babies whose mothers are better educated.

Moreover, inequities persist during childhood. Consider the differences in

![Chart 1: Staying alive depends on circumstances](https://example.com/chart1)

**Infant mortality varies across countries but also by mothers' education within countries.**

**Source:** World Development Report 2006, from Demographic Health Survey (DHS) data.

**Note:** Each vertical line corresponds to one country. The highest point in the line indicates infant mortality among children whose mothers have no education and the lowest is for children whose mothers have completed secondary schooling. The line passes through the average of mortality for the country, weighted by the shares of mothers’ education in the population.
test performance among Ecuadorian children ages three to five years, across population groups defined by parental education, region of residence, and wealth. As Chart 2 shows, those from the wealthiest quartile of households, or with mothers with more than 12 years of education, experience cognitive development in line with international norms (normalized to stay at 100 for all age groups). Children of poor or less-educated households develop skills much more slowly, restricting future opportunities. Such differences in potential are often magnified over life, through the education system and access to work and services.

The massive inequities across countries are sustained by restrictions in international trade and migration that constitute by far the greatest distortions in global markets. The good news is that there has been substantial convergence in some social indicators, notably life expectancy, over the past four decades—with the major exception of the sharp decline in life expectancy in African countries hit by HIV/AIDS in the past decade or so. By contrast, inequality in economic prospects across individuals in the world—as proxied by incomes—experienced a large, long-term rise until the 1980s, driven essentially by differences in country growth rates (see Chart 3). Although there has been a modest decline in this measure since the 1980s, primarily due to the rapid growth of China and India, the gap continues to widen for the slow-growing poorest countries.

Inequity holds back development

Inequalities in opportunity are reproduced over time and across generations, through economic, sociocultural, and political mechanisms—leading to what we call inequality traps. Even in the United States, often called the “land of opportunity,” a recent study finds an intergenerational earnings elasticity of 0.6 (Mazumder, 2005). This implies that a family currently earning half the national average income can expect to take five generations to reach the average.

The same processes that reproduce inequalities can also harm efficiency and overall development. Evidence of that comes in two main categories: microeconomic analyses of the ways in which market imperfections interact with inequalities, and documentation of interactions between political inequalities and institutional formation. Consider the following examples.

Market failures, inequalities, and investment inefficiency

In a world in which markets worked perfectly, investment decisions would have little to do with the income, wealth, or social status of the decision maker. However, for various reasons—mainly economic, but also political—markets are not perfect. In Ghana, for example, land is typically allocated by custom, and security of property rights is thus often linked to the local power structure. Individuals are less likely to leave their land fallow (an investment in long-run productivity of the land) if they do not hold a position of power within either the hierarchy of the village or the hierarchy of the lineage, for fear of having their land reallocated while it is lying fallow (Goldstein and Udry, 2002). Because women rarely hold those positions of power, women’s land is not left fallow often or long enough and is much less productive than men’s. The resulting decline in land productivity is a pure loss for society.

Another example pertains to the forest-savannah region of Southern Ghana, where many farmers cultivate a cassava-maize intercrop. Recently, pineapple cultivation for export to Europe offered a new opportunity. Survey results in the late 1990s revealed that the profitability of pineapple production dominated that of the traditional intercrop, with average returns associated with switching to pineapple in excess of 1,200 percent! Yet only 190 out of 1,070 surveyed plots were used for pineapple. When farmers were asked why they were not farming pineapple, the virtually unanimous response was: “I don’t have the money.” The authors conclude that the

![A girl sits in a cardboard hut at a municipal dump in Honduras.](image)
fixed costs involved in switching crops—and the absence of a well-functioning credit market—prevent a large number of farmers from making a very profitable investment. Output and income levels in these areas are correspondingly below potential (Goldstein and Udry, 1999).

In rural North India, a recent experimental study shows that one’s caste can affect individual performance even at a fairly basic level (see Chart 4). In the first experiment, groups composed of low-caste and high-caste junior high school students were asked to solve mazes and were paid based on the number of mazes they solved. In one game, no personal information about the participants was announced. In a second, caste was announced with each participant’s name and village. In a third, participants were segregated by caste and then each participant’s name, village, and caste were announced in the six-person group.

When caste was not announced, there was no caste gap in performance. But increasing the salience of caste led to a significant decline in the average performance of the low-caste children, regardless of whether the payment scheme was piece rate (with 1 rupee per maze solved) or tournament (the winner who solved the most mazes received 6 rupees per maze solved; others received nothing). When caste was announced, the low-caste children solved 25 percent fewer mazes on average in the piece-rate treatments, compared with the performance of subjects when caste was not announced. While we do not know what the children were thinking, some combination of loss of self-confidence and expectation of prejudicial treatment likely explains the result. If similar declines in productivity occur in real work situations, the private and social losses would be no less important. This could lead to further underinvestment in the education of lower-caste groups, if it leads to the expectation of lower returns.

Political inequalities and the formation of institutions. This category of evidence concerns the relationship between political inequality and the development of governance institutions. One point of departure is the correlation between measures of the quality of institutions and the level of incomes. While debate on the econometrics continues, an important strand of recent literature argues that there is a significant causal relationship between historically formed institutions and contemporary levels of income.

What lies behind this? Historical analysis supports the view that inequality influences institutions. In particular, extreme political inequalities can lead to the design of institutions that are good at extracting and concentrating rents for elites, but less effective in protecting property rights for all: providing broad-based education, risk-management, and economic infrastructure; or fostering broad, competitive financial and industrial structures.

Take, for example, a study of the early institutions and the long-term development paths of European colonies in North and South America (Engerman and Sokoloff, 2002). The authors found that the abundance of unskilled labor prevalent in the South American colonies—where either native Americans or imported African slaves were available in large numbers—combined with the technology of mining and large plantation agriculture to provide the economic base for hierarchical and extractive societies, in which land ownership and political power were highly concentrated. By contrast, in North America, English colonists tried to impose oligarchic structures and extractive economic institutions but failed to do so; there was neither the natural resource base nor ready supplies of subordinate labor.

Leveling the playing fields
What can policymakers do to provide greater equity? In the domestic arena, they need to invest in people; expand access to justice, land, and infrastructure; and promote fairness in markets. In the international arena, they need to focus on the functioning of global markets and the rules that govern them. Governments must seek to reverse the usual order of things, starting with the poorest and most excluded. They must also recognize that personal freedoms are ultimate goals of the development process, and individual incentives are the chief engines of growth and prosperity. Equity must be pursued through well-functioning, competitive markets, not against them.
Expanding opportunities. In the case of human potential, greater opportunities should be reflected in an array of measures in the social sectors—quality basic education for all, preventive health care, and risk management to deal with shocks associated with the weather, health, and labor incomes. As for markets, the focus should include rural roads for market access, tenurial security for peasants and slum dwellers, and microcredit. In the political arena, it should include the “empowerment” agenda—access to justice, accountability of basic service providers, and local democracy.

For example, there is a considerable body of evidence on successful early childhood development interventions in a number of countries. A controlled experiment in Jamaica compared children that were stunted (a measure of long-term undernutrition) with children of normal height. Stunted children who received nutritional and behavioral interventions were able to effectively eradicate a substantial developmental deficit after 18 months in the program. Undernourished kids outside the program never closed the gap (see Chart 5).

Reducing privileges. This matters not only because privileges are often the political obverse of restricting opportunities for poor and middle groups but also because of the association between privilege and growth-sapping structures of protection and rents. Privilege is manifest in various arenas of public action. In the social sectors, many countries sustain regressive subsidies for university schooling, pensions, and health services. In the economic arena, protected industrial sectors, concentrated financial systems, and (often) privatization captured by dominant economic groups are examples—underlining the need to “save capitalism from the capitalists” in the phrase of Raghuram Rajan and Luigi Zingales (2003). And in national political systems, local government, and judicial systems, the influence of the powerful and rich is all too often both unjust and inefficient in its consequences.

A recent study on Latin America found important linkages between inequalities of influence and wealth (De Ferranti and others, 2004). Connected lending can be a source of rapid credit growth and poor asset quality, increasing the vulnerability of financial systems to crisis—and workouts can be highly inequitable. Those with significant financial assets often get their money out before the crash, even experiencing capital gains when exchange rates and asset prices tumble (as in Argentina). And bailouts are biased to insiders in the financial system, especially to larger firms and individuals. The bill is picked up either through higher taxes (typically proportional) or foregone spending (that is often progressive at the margin, implying that lost spending hurts poorer groups most). In terms of policy, this implies building more competitive, open, and accountable financial systems, and institutionalized insurance systems that are less vulnerable to discretionary pressure by those with influence. Such systems would include deposit insurance policies explicitly limited to smaller depositors and employment guarantee schemes, backed by countercyclical fiscal policies.

* * * * *

The bottom line is that a concern with equity is of immense importance for development, both on intrinsic grounds and as the result of a hardheaded analysis of the development process. In fact, equity—defined as equality of opportunity and avoidance of absolute deprivation—is an essential part of the development strategies needed to achieve the Millennium Development Goals by 2015. Policymakers must now find a way to bring equity into the center of the development discourse and policy design. ■


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A War Chest for Fighting HIV/AIDS

Maureen Lewis

With billions of dollars mobilized, the challenge is how to spend the money wisely

AFTER CLOSE to two decades of neglect, battling the HIV/AIDS epidemic has become one of the highest priorities on the global agenda. UNAIDS estimates that some 40 million people are living with HIV—25 million of them in sub-Saharan Africa and 8 million in Asia—with close to 5 million people newly infected in 2004 alone. AIDS-related deaths total about 3 million people each year, with adults and children in Africa dying at the rate of 7,000 per day. In the short term, the loss of a large segment of adults in their prime, particularly women, devastates households. Over the long term, losses in human capital formation pose a further risk by decreasing the intergenerational transfer of knowledge and creating macroeconomic threats, especially in the hardest-hit countries. Prevention through behavioral change has proved difficult, and a vaccine remains elusive.

In response, the international community has mobilized billions of dollars for HIV/AIDS, with many low-income countries already receiving, or pledged to receive, huge sums. However, the recipients of these funds find themselves grappling with tough dilemmas. Could the size of the inflows be so large as to undermine macroeconomic stability or fiscal management? Can they—in a short period—effectively utilize the resources made available, or even the amounts already pledged and committed, given the institutional capacity and governance problems that often plague their health care systems? And can they mobilize the needed “collateral” domestic resources (such as labor, infrastructure, and an institutional base) to rapidly scale up services?

Who’s paying?

Although aid for combating HIV/AIDS is rising rapidly (see Chart 1), there is still expected to be a large gap between what is needed and what is provided in the coming years. UNAIDS estimates that between $9.6 billion and $11.3 billion will be required for low- and middle-income countries in 2005 to fight the pandemic, rising to between $14.1 billion and $18.8 billion by 2007, with further increases in the years ahead as the numbers of
infected rise (UNAIDS, 2005). In 2004, the OECD estimates that some $6 billion was allocated in the developing world to HIV/AIDS, including about $3.7 billion from international sources. This contrasts with about $7 billion in annual commitments to overall development assistance (ODA) for health, which excludes earmarked HIV/AIDS funding.

Donors are currently supporting activities in 140 countries, with about 72 percent of this funding allocated to 25 of them—mostly in highly affected countries in Africa and the Caribbean. For some of these countries, funding is growing so rapidly that the concentration of funds effectively replaces health budgets. The key sources of AIDS funding are domestic public spending; bilateral and multilateral assistance; the Global Fund to Fight AIDS, Tuberculosis and Malaria (financed by bilateral donors and private foundations); the private sector; and household out-of-pocket spending. Bilateral assistance is projected to grow faster than the other sources over the next few years.

The strong international response to HIV/AIDS can be seen at the country level in some of the nine hardest-hit sub-Saharan African countries (see Chart 2). From 2000–02 to 2002–04, the average level of external funding increased significantly in Lesotho (1,100 percent), Swaziland (951 percent), Tanzania (394 percent), and Zambia (698 percent). Only Kenya saw less than a doubling of aid for HIV/AIDS, and it was the country with the largest external commitments in 2000–02.

**Economic ramifications**

Do recipients need to worry about the macroeconomic effects of higher HIV/AIDS funding? In 2002–04, the size of these flows represented some 3 to 25 percent of overall aid flows in 8 of these 9 countries (the exception being Swaziland, with almost 90 percent). These limited proportions suggest that HIV/AIDS funding alone is unlikely to derail overall macroeconomic policy, although it could exacerbate any macroeconomic problems caused by large aid inflows. The macroeconomic effects obviously depend on the size of the economy and on the level of imports, with smaller economies being more vulnerable to the external environment. The larger the aid dependence relative to GDP, the greater the vulnerability to unanticipated shifts in donor flows, because countries lack the discretionary resources to compensate for lost resources.

Recent experiences in Ethiopia and Ghana (Aiyar, Berg, and Hussain, 2005) demonstrate that governments can mitigate these negative effects with creative policies—notably through increasing reserves during periods of donor largesse, thereby saving rather than spending assistance. However, the more common pattern is for governments to ratchet up spending based on aid inflows, thereby making them permanent budget commitments.

As for fiscal impacts—which overshadow the macroeconomic ones—the key factors include the level and sustainability of external aid, competing demands for scarce budget resources, the ability of governments to absorb sharp increases in funding, and the threat of corruption and waste when too much money must be spent in too short a time.

At this point, external HIV/AIDS resources are beginning to dwarf public health allocations (see Chart 2). Dramatic increases have occurred in HIV/AIDS financing, while public health budgets have changed little and in some cases (for example, Mozambique and Zambia) have actually declined. As a result, HIV/AIDS monies exceed overall public health budgets in some countries. In 2003/04, Ethiopia’s external flows were equal to the government’s health budget, but in both Uganda and Zambia, AIDS funds exceeded all public

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**Chart 2**

**Uneven balance**

Dramatic increases in funds to combat HIV/AIDS are starting to dwarf funds available for the overall health care system.

(millions of dollars, period average)

<table>
<thead>
<tr>
<th>Year</th>
<th>Ethiopia</th>
<th>Kenya</th>
<th>Lesotho</th>
<th>Malawi</th>
<th>Mozambique</th>
<th>Swaziland</th>
<th>Tanzania</th>
<th>Uganda</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-02</td>
<td>100</td>
<td>200</td>
<td>150</td>
<td>100</td>
<td>150</td>
<td>200</td>
<td>300</td>
<td>200</td>
<td>300</td>
</tr>
<tr>
<td>2002-04</td>
<td>300</td>
<td>500</td>
<td>350</td>
<td>200</td>
<td>300</td>
<td>500</td>
<td>700</td>
<td>500</td>
<td>700</td>
</tr>
</tbody>
</table>

Source: Lewis (2005a).
health spending by almost 185 percent. For most countries, the sharp increases between 2000/01 and 2003/04 have necessitated rapid changes in the scale and scope of health services. What is puzzling is how countries can accommodate and wisely allocate new resources for HIV/AIDS while their overall health spending declines or only rises modestly.

The volatility and unpredictability of funding will further complicate matters. To begin with, any big improvement in services will require additional hiring. With uncertain flows, expanding the civil service would border on folly, given inflexible public sector labor markets and the inability to downsize when funding contracts or priorities shift. Countries must also rely on imported drugs for HIV/AIDS patients. If the resources or in-kind donations should dry up, the government would need to take over funding, or life-saving treatments would cease. And treatment levels would have to be maintained. Given that AIDS patients are dependent on continued therapy for survival, interruptions in antiretroviral therapy (ART) caused by funding gaps would mean scores of patients succumbing to AIDS.

**Institutions and health care systems**

Simply having good intentions and the right priorities does not guarantee effective programs. It is risky to assume that the complementary inputs will be available and deployed immediately once external funding becomes available. Where delays occur because of lack of any critical input—such as staffing, infrastructure, management, warehousing, logistics, and information on performance and output—productivity is reduced and impact falters. For example, imported drugs that expire on the wharf because of lack of trucks to transport products to warehouses render ART programs useless and waste scarce resources. The infrastructure may be available and the staffing complete, but a missing input leaves programs unable to be productive. Countries need the capacity to manage, spend, and monitor additional donor inflows, despite significant institutional and governance constraints (see box).

A potentially pernicious effect of poorly functioning health care systems are badly designed or under-resourced AIDS treatment programs that lead to low levels of adherence to complex treatment regimes. A recent World Bank study of India (Over and others, 2004) shows that if drugs are not administered according to strict protocols, resistant strains of the virus can develop, jeopardizing treatment options for all. Some degree of chaos and a period of adjustment generally accompany major expansions or shifts of service delivery in scaling up. ART services would be no exception. But the ability of the virus to constantly mutate and adapt to changing circumstances, and the public-good nature of minimizing resistant strains, suggest the need for particular care and attention to protocols, ART management, and health system effectiveness.

In the end, the best way to boost aid effectiveness and marginal returns of a given level of aid (absorptive capacity) is to bolster the health care delivery system. That means strengthening the public entities that deliver and finance health care. The problem is that donors have shown an increasing preference for off-budget and “vertical” public health programs that solely attack specific problems and are divorced from the health system. Why do they prefer this route? It is a logical extension of fund-raising campaigns to link spending with specific diseases. It enables them to ring fence their contributions to allow attribution of their spending. It avoids both the aggravation of ministry of finance oversight as well as the bureaucratic hurdles associated with competing for public funds. And it circumvents the messy integration with health systems, where inputs and outputs are hard to align and outcomes difficult to measure.

Granted, these strategies may achieve quick results, but they also undermine other development objectives. Vertical funds lead to poaching of public sector workers, bidding up wages in the sector, and weakening the existing system. They also bypass orderly budgeting and allocation processes of the government—areas upon which improvements in good governance hinge—removing budget discipline and undermining institutional strengthening. HIV/AIDS programs already rely on the existing infrastructure of physical and human capital, directly and indirectly. Even where HIV/AIDS programs are vertical, stand-alone initiatives, they remain part of the broader public health delivery effort, since diagnosis, referrals, and treatment of opportunistic infections, as well as side effects of ART, continue to be provided by the health system.

**Managing the war chest**

So what can be done to ensure that the monies are used and absorbed effectively—achieving positive outcomes both in containing HIV/AIDS and in macroeconomic management? The following options would certainly be a start.

**Establish an HIV/AIDS Stabilization Fund.** The rapid rise in HIV/AIDS funding requires an instant response in service delivery scale-up. Rigidities in supply responses and the need to compensate for irregularity of donor pledges over time call for alternative arrangements. A stabilization fund that treats large aid inflows as akin to a natural resource boom would allow countries to absorb new resources and save them until circumstances permit their effective use. Because pledges have already been made, the stabilization fund would simply function as a repository of donor contributions—whether bilateral or multilateral. Terms of trade and exchange rate problems could be better managed, big annual disbursements achieved, and productivity and impact

“The best way to boost aid effectiveness and marginal returns of a given level of aid (absorptive capacity) is to bolster the health care delivery system.”
Dysfunctional health systems

A recent review of institutions and governance in the health sector points to the severity of the institutional challenges (Lewis, 2003b). Absenteeism among medical staff shows rates averaging between 28 and 42 percent at primary health care clinics, jumping to 68 percent in Uganda and 74 percent in Bangladesh. An exercise in tracking public funds from ministries of finance to points of service shows that local capture, leakage, and bureaucratic impediments resulted in 80 percent of non-salary budgets never reaching frontline clinics in Ghana, 70 percent in Uganda, and 40 percent in Tanzania. Household surveys show that in the majority of countries, patients are paying under the table for treatment at public clinics, a violation of free health care mandates and a symbol of poor governance. These governance challenges raise doubts about the value of simply increasing funding, or of the need for just more health workers.

Shortages of staffing for expanding ARV treatment that have raised hackles in the international community have as much to do with limitations of government management as they do with external pressures from the international financial institutions to limit hiring. The working conditions of civil servants where there are missing supplies and drugs, few opportunities for advancement, and poor management contribute to low morale and to out-migration. In Zimbabwe, prior to the disintegration of the health system, the well-run civil service retained workers, including those in the health sector. As working conditions deteriorated, the quality of management eroded, and the political and economic environment became more uncertain, the higher salaries and better management outside the country became attractive options.

Enhanced. Transparent reporting and appropriate management would be key. Such a fund would imitate the sequestered oil funds of countries like Azerbaijan and Norway, and Botswana, with its diamond earnings. The international financial institutions have experience in helping countries undertake such efforts, and they could simply add oversight in helping countries set up such a fund.

“Tax” incoming funds. A tax of, say, 10 percent on all incoming funds could be levied to pay for the upgrading of the health care system. This is a cost donors have been reluctant to underwrite, even though the bulk of new monies would need to rely on the health system to be effective. Such a tax would spread the cost of scaling up among donors and ensure that governments alone were not paying out of their already scarce funds. It would have to be combined with more concerted efforts on health system upgrading, preferably in concert with the options below, which allow the effective integration and application of new resources.

Attack poor health system performance. Health systems have been effectively overlooked in the drive to respond to the HIV/AIDS crisis, but it is the systems and their ability to function that determine whether services can be delivered, patients referred for treatment, and side effects treated. Civil service reform, budget management changes, and greater accountability for policies, programs, and fiduciary functions not only deserve attention but are also critical to effective scaling up in health care and HIV/AIDS. Policymakers can improve delivery while husbanding scarce resources by both addressing governance problems and improving efficiency through such actions as using day beds in clinics; contracting out ancillary and direct service provision; issuing vouchers for AIDS patients; and using supervised paraprofessionals.

Step up nongovernmental involvement. Delivery of prevention and treatment should expand beyond the government. This is not to suggest that governments abrogate their responsibilities, but that they continue to coordinate and find innovative means of service delivery. Take the model in Haiti, where minimally trained outreach workers can reach out to low-income communities with the backing of highly technical management and oversight. Greater reliance on NGOs in delivery, hiring temporary workers for government programs, or government sponsorship of joint training offer possible solutions to some of the bottlenecks.

The AIDS pandemic’s devastation has spurred an overwhelming response from the international community, and after years of limited funding, donors are rapidly making up for past shortfalls. The question is how well and how fast low-income countries can respond to the new, and possibly uncertain, flow of funds for a single, albeit devastating, disease. Weak institutions and fragile budgeting undermine absorption of funds. And the focus on strong and well-funded HIV/AIDS programs without requisite attention paid to the broader health delivery system is neither sustainable nor good policy.

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References:
HEN MIGRANTS send home part of their earnings in the form of either cash or goods to support their families, these transfers are known as workers’ or migrant remittances. They have been growing rapidly in the past few years and now represent the largest source of foreign income for many developing countries.

It is hard to estimate the exact size of remittance flows because many transfers take place through unofficial channels. Worldwide, officially recorded international migrant remittances are projected to exceed $232 billion in 2005, with $167 billion flowing to developing countries. These flows are recorded in the balance of payments; exactly how to record them is being reviewed by an international technical group. Unrecorded flows through informal channels are believed to be at least 50 percent larger than recorded flows (see Picture This on page 44). Not only are remittances large but they are also more evenly distributed among developing countries than capital flows, including foreign direct investment, most of which goes to a few big emerging markets. In fact, remittances are especially important for low-income countries.

How is the money transferred?

A typical remittance transaction takes place in three steps. In step 1, the migrant sender pays the remittance to the sending agent using cash, check, money order, credit card, debit card, or a debit instruction sent by e-mail, phone, or through the Internet. In step 2, the sending agency instructs its agent in the recipient’s country to deliver the remittance. In step 3, the paying agent makes the payment to the beneficiary. For settlement between agents, in most cases, there is no real-time fund transfer; instead, the balance owed by the sending agent to the paying agent is settled periodically according to an agreed schedule, through a commercial bank. Informal remittances are sometimes settled through goods trade.

The costs of a remittance transaction include a fee charged by the sending agent, typically paid by the sender, and a currency-conversion fee for delivery of local currency to the beneficiary in another country. Some smaller money transfer operators (MTOs) require the beneficiary to pay a fee to collect remittances, presumably to account for unexpected exchange-rate movements. In addition, remittance agents (especially banks) may earn an indirect fee in the form of interest (or “float”) by investing funds before delivering them to the beneficiary. The float can be significant in countries where overnight interest rates are high.

Why are remittances helpful?

Remittances are typically transfers from a well-meaning individual or family member to another individual or household. They are targeted to meet specific needs of the recipients and thus, tend to reduce poverty. In fact, World Bank studies, based on household surveys conducted in the 1990s, suggest that international remittance receipts helped lower poverty (measured by the proportion of the population below the poverty line) by nearly 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 percentage points in Ghana.

How are remittances used? In poorer households, they may finance the purchase of basic consumption goods, housing, and children’s education and health care. In richer households, they may provide capital for small businesses and entrepreneurial activities. They also help pay for imports and external debt service, and in some countries, banks have been able to raise overseas financing using future remittances as collateral.

Remittance flows tend to be more stable than capital flows, and they also tend to be counter-cyclical—increasing during economic downturns or after a natural disaster in the migrants’ home countries, when private capital flows tend to decrease. In countries affected by political conflict, they often provide an economic lifeline to the poor. The World Bank estimates that in Haiti they represented about 17 percent of GDP in 2001, while in some areas of Somalia, they accounted for up to 40 percent of GDP in the late 1990s.

Is there a downside?

There are a number of potential costs associated with remittances. Countries receiving migrants’ remittances incur costs if the emigrating workers are highly skilled, or if their departure creates labor shortages. Also, if remittances are large, the recipient country could face an appreciation of the real exchange rate that may make its economy less competitive internationally. Some argue that remittances can also create dependency, undercutting recipients’ incentives to work, and
thus slowing economic growth. But others argue that the negative relationship between remittances and growth observed in some empirical studies may simply reflect the counter-cyclical nature of remittances—that is, the influence of growth on remittances rather than vice-versa.

Remittances may also have human costs. Migrants sometimes make significant sacrifices—often including separation from family—and incur risks to find work in another country. And they may have to work extremely hard to save enough to send remittances.

**Can high transaction costs be cut?**

Transaction costs are not usually an issue for large remittances (made for the purpose of trade, investment, or aid), because, as a percentage of the principal amount, they tend to be small, and major international banks are eager to offer competitive services for large-value remittances. But in the case of smaller remittances—under $200, say, which is often typical for poor migrants—remittance fees can be as high as 10–15 percent of the principal amount.

Cutting transaction costs would significantly help recipient families. How could this be done? First, the remittance fee should be a low fixed amount, not a percent of the principal, since the cost of remittance services does not really depend on the amount of principal. Indeed, the real cost of a remittance transaction—including labor, technology, networks, and rent—is estimated to be significantly below the current level of fees.

Second, greater competition will bring prices down. Entry of new market players can be facilitated by harmonizing and lowering bond and capital requirements, and avoiding over-regulation (such as requiring full banking licenses for money transfer operators). The intense scrutiny of money service businesses for money laundering or terrorist financing since the 9/11 attacks has made it difficult for them to operate accounts with their correspondent banks, forcing many in the United States to close. While regulations are necessary for curbing money laundering and terrorist financing, they should not make it difficult for legitimate money service businesses to operate accounts with correspondent banks.

An example where competition has spurred reductions in fees is on the U.S.–Mexico corridor, where remittance fees have fallen by 56 percent from over $26 (to send $300) in 1999 to about $11.50 now. In addition, some commercial banks have recently started providing remittance services for free, hoping that would attract customers for their deposit and loan products. And in some countries, new remittance tools—based on cell phones, smart cards, or the Internet—have emerged.

Third, establishing partnerships between remittance service providers and existing postal and other retail networks would help expand remittance services without requiring large fixed investments to develop payment networks. However, partnerships should be nonexclusive. Exclusive partnerships between post office networks and money transfer operators have often resulted in higher remittance fees.

Fourth, poor migrants need greater access to banking. Banks tend to provide cheaper remittance services than money transfer operators. Both sending and receiving countries can increase banking access for migrants by allowing origin country banks to operate overseas; by providing identification cards (such as the Mexican *matrícula consular*), which are accepted by banks to open accounts; and by facilitating participation of microfinance institutions and credit unions in the remittance market.

**Can governments boost flows?**

Governments have often offered incentives to increase remittance flows and to channel them to productive uses. But such policies are more problematic than efforts to expand access to financial services or reduce transaction costs. Tax incentives may attract remittances, but they may also encourage tax evasion. Matching-fund programs to attract remittances from migrant associations may divert funds from other local funding priorities, while efforts to channel remittances to investment have met with little success. Fundamentally, remittances are private funds that should be treated like other sources of household income. Efforts to increase savings and improve the allocation of expenditures should be accomplished through improvements in the overall investment climate, rather than targeting remittances. Similarly, because remittances are private funds, they should not be viewed as a substitute for official development aid.

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**Transfer costs**

Remittance fees could be reduced significantly if they were converted to a flat fee instead of a percent of the principal transferred.

Approximate cost of remitting $200 (percent of principal)

<table>
<thead>
<tr>
<th>Major MTOs</th>
<th>Banks</th>
<th>Other MTOs</th>
<th>Hawala</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium–Nigeria</td>
<td>12</td>
<td>6</td>
<td>9.8</td>
</tr>
<tr>
<td>Belgium–Senegal</td>
<td>10</td>
<td>–</td>
<td>6.4</td>
</tr>
<tr>
<td>Hong Kong–Philippines</td>
<td>4.5</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>New Zealand–Tonga ($300)</td>
<td>12</td>
<td>3</td>
<td>8.8</td>
</tr>
<tr>
<td>Russia–Ukraine</td>
<td>4</td>
<td>3</td>
<td>2.5</td>
</tr>
<tr>
<td>South Africa–Mozambique</td>
<td>–</td>
<td>1</td>
<td>–</td>
</tr>
<tr>
<td>Saudi Arabia–Pakistan</td>
<td>3.6</td>
<td>0.4</td>
<td>–</td>
</tr>
<tr>
<td>UAE–India</td>
<td>5.5</td>
<td>5.2</td>
<td>2.3</td>
</tr>
<tr>
<td>United Kingdom–India</td>
<td>11</td>
<td>6</td>
<td>–</td>
</tr>
<tr>
<td>United Kingdom–Philippines</td>
<td>–</td>
<td>0.4-5.0</td>
<td>–</td>
</tr>
<tr>
<td>United States–Colombia</td>
<td>–</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>United States–Mexico</td>
<td>9</td>
<td>3</td>
<td>4.7</td>
</tr>
<tr>
<td>United States–Philippines</td>
<td>1.2-2.0</td>
<td>0.4-1.8</td>
<td>–</td>
</tr>
</tbody>
</table>

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OVER the past fifteen years, international migrant remittances have become increasingly prominent—exceeding $232 billion in 2005, with $167 billion flowing to developing countries. This amount, however, reflects only transfers recorded in the balance of payments. Unrecorded flows through informal channels are believed to be at least 50 percent higher than recorded flows. In 2004, recorded remittances were the second largest source of external financing in developing countries, after foreign direct investment, and amounted to more than twice the size of official aid. Remittances are less volatile than most other sources of foreign exchange earnings for developing countries.

**Remittances are the second largest source of finance for developing countries.**

![Graph showing remittances compared to other sources of finance for developing countries](image)

While capital flows tend to rise during upswings of economic cycles and decline in bad times, remittances tend to be countercyclical relative to recipient countries’ economies. They tend to rise when the recipient country suffers an economic downturn following a financial crisis, natural disaster, or political conflict, as migrants transfer more funds during hard times to help their families and friends.

**Not surprisingly, remittances rise during financial crises.**

![Graph showing remittances increase during financial crises](image)

The top three recipients of remittances in 2004 were India, China, and Mexico. But it is smaller countries, such as Tonga, Moldova, and Lesotho, that top the list when controlling for the size of the economy—for example, as a share of GDP. On average, the share of remittances in GDP is twice as large in low-income countries as in middle-income countries.

**Larger countries tend to receive more remittances in dollar terms . . .**

![Graph showing remittances in dollar terms for various countries](image)

. . . but, in terms of GDP, smaller countries receive the most.

![Graph showing remittances as a percentage of GDP for various countries](image)
Rich countries are the main source of remittances. The United States is by far the largest source, with $39 billion in outward flows. Saudi Arabia (classified as a high-income country in 2005) is the second largest, followed by Switzerland and Germany. But when expressed as a share of GDP, outward remittances were the largest in the upper middle-income countries (0.7 percent of GDP compared to 0.2–0.4 percent of GDP in other countries). Although it is conventionally believed that migration flows are South-North and remittance flows North-South, South-South migration is estimated to be at least as large as South-North migration, and South-South remittances are 30–45 percent of the remittances received by the South.

Household survey data show that remittances have reduced the poverty headcount ratio significantly in several low-income countries—by 11 percentage points in Uganda, 6 percentage points in Bangladesh, and 5 in Ghana. For the very poor, remittances may not provide more income than could have been earned locally. For the very rich, remittances may even be smaller than the loss of income due to migration. But for the middle-income groups, they enable recipients to move up to a higher income group. In Sri Lanka, for example, households from the third through the eighth income decile moved up the income ladder thanks to remittances.

Remittances can improve a country’s creditworthiness and enhance its access to international capital markets. The ratio of debt to exports, a key indebtedness indicator, decreases significantly when remittances are included.

Remittances help reduce poverty . . .

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Islamic Finance is developing at a remarkable pace. Since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries. They are concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia the biggest hubs), but are also appearing in Europe and the United States. Total assets worldwide are estimated to exceed $250 billion, and are growing at an estimated 15 percent a year (although cross-border data remain scarce).

Islamic financial products are aimed at investors who want to comply with the Islamic laws (Sharia) that govern a Muslim’s daily life. These laws forbid giving or receiving interest (because earning profit from an exchange of money for money is considered immoral); mandate that all financial transactions be based on real economic activity; and prohibit investment in sectors such as tobacco, alcohol, gambling, and armaments. Islamic financial institutions are providing an increasingly broad range of many financial services, such as fund mobilization, asset allocation, payment and exchange settlement services, and risk transformation and mitigation. But these specialized financial intermediaries perform transactions using financial instruments compliant with Sharia principles.

What are the reasons behind the recent growth in Islamic finance? One is the strong demand from a large number of immigrant and nonimmigrant Muslims for Sharia-compliant financial services and transactions. A second is growing oil wealth, with demand for suitable investments soaring in the Gulf region. And a third is the competitiveness of many of the products, attracting Muslim and non-Muslim investors. Yet despite this rapid growth, Islamic banking remains quite limited in most countries and is tiny compared with the global financial system. For it to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles—notably on the regulatory front. Islamic banking has so far been spared from a serious financial crisis, with the exception of a few small cases (such as the Dubai Islamic Bank in 1998 and Ihlas Finans in Turkey in 2001). Nevertheless, building confidence in a new industry is fundamental for the development of Islamic finance.

What is Islamic financing?
The fact that Islamic laws prohibit paying and receiving interest does not imply that they frown on making money or encourage reverting to an all-cash or barter economy. They encourage all parties in a financial transaction to share the risk and profit or loss of the venture. Depositors in Islamic banking can be compared to investors or shareholders, who earn dividends when the bank makes a profit or lose part of their savings if the bank posts a loss. The rationale is to link the return in an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth. Islamic financial instruments take the form of contracts between providers and users of funds to...
manage risk. On the asset side, Islamic banks engage in investment and trading activities according to the various contracts available (see box). On the deposit side, funds are mainly mobilized on the basis of a Mudaraba contract or an interest-free loan contract (Qard Al Hasan). Overall, Islamic banks offer their depositors four classes of accounts: current, savings, investment, and special purpose investment accounts.

**Recent trends**

In countries where Islamic banking is operating, its coverage and extent vary significantly from situations where the sector is entirely Islamic (Iran and Sudan), to others where conventional and Islamic systems coexist (Indonesia, Malaysia, Pakistan, and the United Arab Emirates), to countries where there are one or two Islamic banks. The current trend seems to be toward separation between Islamic and conventional banks. Some countries have opted for a clear separation between these banks, while others have allowed conventional banks to set up Islamic windows, opening the way for some of the largest multinational banks to participate. Even large conventional banks in the United States and Europe have opened Islamic financing windows.

The Islamic debt market—both foreign and domestic—has been the most rapidly growing segment of Islamic finance. In Malaysia, for example, Islamic securities accounted for 42 percent of total outstanding private debt securities by end-2004, and Islamic securities accounted for 25 percent of total outstanding bonds.

The international Islamic bond market is divided into sovereign (and quasi-sovereign) and corporate Sukuk (or Islamic note) markets—a particularly innovative, rapidly growing area. These asset-based bonds of medium-term maturity have been issued internationally by sovereign and corporate entities. Sukuk paper has the advantage of competitive pricing as a risk-mitigation structure. In 2001, the Bahrain Monetary Agency was among the first central banks to issue this paper, in its case in three- and five-year maturities, with most issues oversubscribed. Qatar issued Qatar Global Sukuk with a seven-year maturity (the largest issue ever at $700 million).

The German State of Saxony-Anhalt became the first non-Muslim issuer to tap the global Islamic debt market in 2004, raising some 100 million euros via a Sukuk issue in an innovative effort to appeal to a broader range of investors. More recently, the Islamic Development Bank created the first program for repeat issues of Sukuk. Widespread Sukuk paper issuance could lay the groundwork for the emergence of Islamic capital markets. But while the Sukuk market is developing rapidly, it remains primarily a market where holders keep bonds to maturity with limited secondary market trading.

On the equity side, two indices were launched in 1999 to provide a benchmark for equity prices for investment by Islamic financial institutions: the Dow Jones Islamic Market (DJIM) Index in Bahrain and the Financial Times Stock Exchange Global Islamic Index Series (GIIS). Although these indices have since been published worldwide, Islamic indices remain in their infancy and play a limited role in Islamic financial markets.

**A range of Islamic financial instruments**

While the main types of Islamic financial instruments are conceptually simple, they may become complicated in practice as some banks combine aspects of two or more types of instruments to suit customer requirements.

**Debt instruments** include Murabaha, a purchase and resale contract in which a tangible asset is purchased by a bank at the request of its customer from a supplier, with the resale price determined based on cost plus profit markup; Salam, a purchase contract with deferred delivery of goods (opposite to Murabaha), which is mostly used in agricultural finance; Istisna, a predelivery financing and leasing instrument used to finance long-term projects; and Qard al-Hasan (benevolent loan), an interest-free loan contract that is usually collateralized.

**Quasi-debt instruments** include Ijara, a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the bank) bears all risks associated with ownership. The asset can be sold at a negotiated market price, effectively resulting in the sale of the Ijara contract. The Ijara contract can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset’s expected life.

**Profit-and-loss-sharing instruments** include Musharaka, an equity participation contract under which a bank and its client contribute jointly to finance a project. Ownership is distributed according to each party’s share in the financing. They also include Mudaraba, a trustee-type finance contract under which one party provides the capital for a project and the other party provides the labor. Profit sharing is agreed between the two parties to the Mudaraba contract and the losses are borne by the provider of funds except in the case of misconduct, negligence, or violation of the conditions agreed upon by the bank.

Many Islamic financial institutions, particularly in Bahrain, Malaysia, and Sudan, have been gearing up for further expansion by continuing to develop, refine, and market innovative Islamic financial instruments, on both the asset and liability sides. In recent years, many new Islamic financial products have been developed and are increasingly used in financial market activities, including equity and bond trading and investment, Islamic insurance and reinsurance (Takaful/re-Takaful), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products.

In recent years, Islamic investment funds have prospered in the Gulf countries and Malaysia. Among the different categories are equity funds, real estate and property funds, Murabaha funds, commodity funds, and leasing funds. Islamic equity funds are the most common, and total assets worldwide grew more than 25 percent over the 1997–2003 period. In Malaysia, the number of Islamic investment funds reached 71 in 2004, up from 7 in 1995, and their share of net asset value as a percentage of total funds more than doubled over this 10-year period (see chart).
A range of Islamic instruments is also in use in several countries for financing specific government projects and procurement of goods and services. In recent years, several countries, such as Sudan and Iran, have introduced short-term government securities based mainly on participation principles for funding government operations and liquidity sterilization.

**Developing money markets**

Designing Islamic instruments for monetary operations has proven conceptually difficult. In countries with a dual banking system, the lack of noninterest-bearing securities has limited the scope of monetary management. The liquid nature of banks’ liabilities, related to the predominance of deposits of short-term maturities, predisposes the system to hold substantial liquid assets and excess reserves. This, in turn, inhibits financial intermediation and market deepening. Difficulties in defining rates of return on these instruments have also constrained the development of money and interbank markets.

Developing these markets is indispensable for the conduct of monetary policy and financial market deepening. The inadequate development or absence of these markets in many countries constrains central bank intervention through indirect instruments and has occasionally encouraged the use of direct controls on credit. The absence of well-organized, liquid interbank markets—that can accept banks’ overnight deposits and offer them lending to cover short-term financial needs—has exacerbated banks’ tendencies to concentrate on short-term assets.

Progress in effective liquidity management calls for adopting a comprehensive, integrated approach to developing money and securities markets. It would also require establishing an efficient lender of last resort facility; developing well-suited interbank instruments for active interbank trading or for monetary operations; actively utilizing securitization techniques to manage the maturity and risk spectrum of assets and liabilities; and making available risk management and hedging instruments, which presupposes the resolution of various legal, institutional, and accounting issues.

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**Regulating and supervising Islamic finance**

Undoubtedly, one of the biggest challenges is developing a framework for governing, supervising, and regulating Islamic banks. To begin with, there is no common approach among countries where Islamic banking exists. One of the two main views—held by regulators in Malaysia and Yemen, for example—is that Islamic banks should be subject to a supervisory and regulatory regime of central banks that is entirely different from that of conventional banks. The second main view recognizes the uniqueness of Islamic banks’ activities, but favors putting them under the same central bank supervision and regulatory regime as that for conventional banks, with slight modifications and special guidelines that are usually formalized in occasional central bank circulars. Bahrain and Qatar are examples of countries that practice this latter form of central bank supervision and regulation.

Since the late 1990s, however, the Islamic banking world has stepped up efforts to standardize regulation and supervision. The Islamic Development Bank is playing a key role in developing internationally acceptable standards and procedures and strengthening the sector’s architecture in different countries. Several other international institutions are working to set Sharia-compliant standards and harmonize them across countries. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Finance Service Board (IFSB), the International Islamic Financial Market, the Liquidity Management Center, and the International Islamic Rating Agency.

A number of countries and institutions have adopted accounting standards developed by the AAOIFI, which complement the International Financial Reporting Standards. The IFSB aims to promote the development of a prudent and transparent Islamic financial services industry and provides guidance on the effective supervision and regulation of institutions offering Islamic financial products. The IFSB has recently finalized standards on capital adequacy and risk management, and has made progress in developing standards on corporate governance. Once developed and accepted, these international standards will assist supervisors in pursuing soundness, stability, and integrity in the world of Islamic finance.

There is an ongoing debate over the fact that Islamic banks do not separate fund management and investment activities from commercial banking. From a supervisory perspective, Islamic banks are often compared with universal banks and mutual funds, which may cause technical difficulties for regulators and supervisors. For instance, an Islamic bank acting as a Mudarib—an agent in Mudaraba, a type of profit-and-loss-sharing (PLS) instrument—might be considered more a fund manager than a bank. Consequently, in these cases, some supervisors support taking the supervisory approaches applied to conventional fund managers. There are instances in which various risks are aggregated into a single Islamic instrument and offered within a single institution (for example, Salam) and the principle of pooled savings and risk sharing in the outcome applies. Closer examination of the character of the underlying transaction is needed for effective supervision, however.

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**A rapid rise**

The net asset value of Islamic investment funds as a share of all Malaysian investment funds more than doubled over the past decade.

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of Net Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>10%</td>
</tr>
<tr>
<td>1996</td>
<td>15%</td>
</tr>
<tr>
<td>1997</td>
<td>20%</td>
</tr>
<tr>
<td>1998</td>
<td>25%</td>
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<td>1999</td>
<td>30%</td>
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<td>2000</td>
<td>35%</td>
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<tr>
<td>2001</td>
<td>40%</td>
</tr>
<tr>
<td>2002</td>
<td>45%</td>
</tr>
<tr>
<td>2003</td>
<td>50%</td>
</tr>
<tr>
<td>2004</td>
<td>55%</td>
</tr>
</tbody>
</table>

Source: International Organization of Securities Commissions.
Because of the risks associated with the activities carried out by these institutions and the contracts that govern their mobilization of funds, some argue that their supervision and regulation require a much broader coverage extending beyond the banking sector. Moreover, the risk-sharing nature of liability contracts has raised issues concerning the definition of capital and the capital adequacy ratio.

Some analysts also argue that an appropriate regulatory framework for Islamic banking must place greater emphasis on operational risk management and information disclosure than is normally the case in conventional banking. This argument is based on the specific nature of the risk profile in Islamic financial intermediation, relating to both PLS and non-PLS modes of financing. Investment risk is considered the most critical operational risk affecting Islamic banks’ PLS activities. While PLS modes may shift the direct risk to investment depositors, they may also expose Islamic banks to risks normally borne by equity investors rather than holders of debt. PLS modes involve banks in activities that go beyond conventional banking, such as the determination of profit-and-loss-sharing ratios on investment projects. Moreover, banks’ exposure is heightened because of the lack of recognizable default on the part of the agent-entrepreneur in PLS contracts, except in cases of negligence or mismanagement.

If a project posts a loss under a Mudaraba contract, for instance, the bank would not be able to recover its loan since it would bear all the financial losses. This situation would not constitute a default on the part of the entrepreneur whose liability is limited to his time and efforts. Furthermore, there is no legal means allowing banks to control the agent-entrepreneur who manages the business financed through Mudaraba contracts, and banks cannot reduce risk by requiring a collateral or other guarantee in PLS modes of financing.

**Additional hurdles**

Besides developing money markets and sorting out regulation and supervision, policymakers will need to tackle two other big hurdles.

**Data collection.** The lack of aggregate data makes it virtually impossible to compare Islamic banks across countries, which, together with the absence of common reporting and accounting standards, complicates the work of supervisors. No data are available on cross-border Islamic banking, the amount of cross-border Islamic financial transactions, and real-estate investment based on Islamic principles for developed countries. Some central banks, including those in Bahrain, Malaysia, and Turkey, have begun to produce a chapter in their annual reports on Islamic banks, putting them in a separate group, with aggregated data that provide information on the size and growth of Islamic banking at the country level. Nevertheless, a multilateral effort is needed to collect and consolidate cross-country data.

**Capital markets.** The markets for Islamic instruments and government securities remain shallow and an organized international Islamic financial market is still nascent. The sector must improve the range and sophistication of asset and liability classes and develop new instruments and financial techniques that would enable Islamic banks to diversify their balance sheets.

Adoption of a common position on certain financial instruments would help develop Islamic finance and improve its competitiveness globally. For example, a number of issues relating to speculation and the use of derivatives must be resolved before a fully functioning Islamic stock market can evolve. While arbitrage and short selling are not acceptable under Sharia, other financial transactions appear to be, in practice, subject to varying interpretations. For instance, transactions involving the purchase and sale of debt contracts in secondary markets are permissible only in Malaysia.

**In sum**

Resolving these important issues, as well as adopting best practices for supervision and accounting, are critical for future market and industry development. For the foreseeable future, supervisory authorities will continue to face the dual challenges of understanding the industry and striking a balance between providing effective supervision and facilitating the industry’s legitimate aspirations for further growth and development.

These challenges can be overcome if the concerned central banks and institutions enhance their multilateral cooperation, and create the appropriate environment and conditions. These conditions would create a level playing field and provide the infrastructure needed for the industry’s market-driven development. A sound, well-functioning Islamic financial system can pave the way for the regional financial integration of the countries involved. It can also contribute to their economic and social development, by financing the economic infrastructure and creating job opportunities.

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For further reading on Islamic finance:

A blueprint for a benevolent hegemon

mirrored the reduction of the U.S. budget deficit. As Bergsten and Michael Mussa rightly observe, fiscal deficits absorb national saving, boost U.S. interest rates, and attract foreign saving. This was true in the 1980s and is even more true today. Nevertheless, the argument that foreign capital inflows reflect the U.S. position as an attractive haven for foreign investors may still be relevant.

The solutions recommended by Mussa are inescapable. The United States must cut its budget deficit, and its major partners must increase domestic demand relative to output. Moreover, China and other Asian countries must stop intervention to maintain overvalued exchange rates—which is in violation of their international obligations—and contribute to the international adjustment process. Somewhat less convincing are Bergsten’s calls for “exchange rate action,” including coordinated intervention and possibly “target zones.” Earlier attempts to fix exchange rates have been costly, and it does not seem logical to advocate nominal exchange rate rigidities for the now-floating advanced countries while condemning them in the case of China and other emerging market countries.

The second issue is the threat of rising fuel prices. Philip Verleger warns that current strains in world energy markets signal a “gathering storm” and require urgent action. The sources of these strains include the expansion of world demand stemming from the emergence of China and India as major importers, political instability in several producing countries, insufficient inventories, bottlenecks in transportation and refining, and insufficient conserva-

Despots or democrats?

“Discuss the implications of the following three facts for Africa today. All high-income countries in the world today are democracies. It is not generally the case that higher incomes lead to more democracy. The dozen or so initially poor countries that sustained high growth since 1960, and which are most likely on the path to wealth, all started out with—at best—a limited degree of democracy.”

This is an exam question for undergraduate nightmares and, one hopes, a paradox that also keeps thoughtful policymakers awake at night. Should one provide the traditional answer—that development requires autocracy first and democracy only once incomes are higher? Or should one go for the more modern leap of faith—if you build it (democracy), they (the investors) will come (and the terrorists will leave)?

The Democracy Advantage is an eloquent and refreshing attempt to bolster the modern pro-democracy position. The authors provide strong arguments against the idea that autocracies are good for development in low-income countries. As they show, most autocracies (or dictatorships of any kind) do badly in terms of both average growth and ability to deal with crises. Even initially pro-growth autocrats tend to lapse into corruption and allow too much rent seeking and too little productive investment. Even the best autocrats, once they die, are followed by a deluge.

But the book is less convincing on the success cases since 1960 (many of which are in East Asia). To the authors’ credit, they tackle the issue head on—for example, in the context of China. But you really cannot have it both ways. If China has grown rapidly (which it most certainly has), this was not initially due to democracy, and it has not yet led to democracy. There is no reasonable way to avoid acknowledging this point.

What did China and other recent successes do? As the authors acknow-
tion by consumers. The steep rise in fuel prices predicted by the author has already materialized and models project that further increases could seriously damage the U.S. economy.

Verleger supports the idea of a U.S. gasoline tax, matched by a cut in other domestic taxes, to achieve a substantial reduction in demand. But he knows the political obstacles are high. Short of this, the United States could encourage inventory accumulation and the upgrading of refinery capacity and encourage substitution away from petroleum products. Most important, it should negotiate an international agreement to stabilize world prices.

The third issue is trade liberalization. Scott Bradford, Paul Grieco, and Gary Hufbauer state that the United States has benefited greatly from globalization in the area of trade. This statement is consistent with the consensus among economists that trade fosters efficiency, exploits economies of scale, and helps to spread technological innovations. It is also supported by an impressive array of empirical evidence. The postwar gains from trade liberalization are estimated at $1 trillion for the world as a whole and $600 billion (5 percent of GDP) for the United States.

Very large gains can also be expected from future trade liberalization, notably in services and agriculture. Both of these areas are of particular importance to the United States, and agriculture is, of course, of special concern to developing countries. But further trade liberalization will require strong U.S. leadership. Congress will have to extend Trade Promotion Authority so that the Doha Round of trade negotiations can succeed, and reauthorize U.S. membership in the World Trade Organization. The United States will also have to resist domestic protectionist pressure—by explaining clearly the benefits of trade liberalization and by providing more generous assistance to those who bear the costs of globalization (even if they are relatively few compared with those who will gain from it).

Finally, the book looks at a number of other important policy challenges. Jan Boyer and Edwin Truman analyze the rising importance of the large emerging market economies— including Brazil, China, India, and Russia—and suggest a cooperative approach to addressing this development, including better representation of these countries in the international financial institutions. Other contributions deal with developing countries, the international monetary system, and the problems of U.S. immigration policy. All the authors offer thorough analysis and constructive advice. This book is essential reading for anyone interested in international policy.

Ernesto Hernandez-Cata
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The authors’ assessment of history over the past 100 years or more in Latin America clearly shows that democracies are not only capable of collapsing under the weight of populism and misgovernance but also that “democracy” often turns out to be a sham. The authors know this and rightly emphasize the need for real democracy, with true accountability, and they have constructive proposals for how to monitor and support this. But since “free and fair elections” became more fashionable, elites have gotten much better at “managing” the electoral process (sadly, it turns out not to be too difficult). So should developed countries help by providing massive inflows of aid to poor and somewhat democratic countries? Would this strengthen the middle class, enable a boom in manufactured exports, and lead to better institutions, such as the rule of law? Buy the book and draw your own conclusions.

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Morton H. Halperin, Joseph T. Siegle, and Michael M. Weinstein
The Democracy Advantage
How Democracies Promote Prosperity and Peace
Taylor & Francis, Inc., 2004, 290 pp., $28.50 (cloth).
in the face of output fluctuations. But because emerging markets hit by shocks often lose market access, he does not think of consumption smoothing as a major welfare gain either. Third, capital inflows and outflows can help residents reduce risk by diversifying portfolios. Finally, capital inflows, if they take the form of foreign direct investment (FDI), may enable the country to engage in new activities by creating access to intellectual property rights and new financial services and products.

Minimizing volatility
What can countries do if they want to benefit from a more open capital account yet minimize the cost associated with volatility? Williamson suggests that overall volatility may be reduced by shifting the composition of capital flows from loans to equity and, within equity, from portfolio investments to FDI. As for debt issuance, he strongly favors emerging markets denouncing much of their borrowing in their own currencies. Private firms in emerging markets should also be discouraged from issuing foreign currency–denominated debt since currency mismatches aggravate crises.

To further reduce the risk of currency mismatch, multilateral development banks should change their lending practices by borrowing in a synthetic currency whose value would be defined by a basket of emerging market currencies. The banks could then avoid currency exposure by lending to emerging markets in their own currencies. And commercial banks everywhere should be required to provision on the basis of historical experience with loan defaults.

Countries must do their bit
While Williamson thinks these measures will moderate the volatility of capital flows, he acknowledges that they will not end the boom-bust cycles. Emerging markets should thus implement policies that make them more resilient to volatility. First, public debt should be reduced to a level that allows for fiscal expansion during a recession and a countercyclical monetary policy. Second, countries should avoid overvalued exchange rates—leaving enough exchange rate flexibility to give borrowers an incentive to avoid currency mismatches. Third, governments should develop local government and corporate bond markets. Fourth, they should retain the right to use capital controls during periods of large-scale capital inflows.

While all these proposals make sense, some are more likely to be implemented than others. Williamson himself suggests that priority be given to a switch in lending practices by multilateral development banks, and that emerging markets begin issuing debt in domestic currency local bonds and GDP-linked international bonds.

Would these measures significantly reduce volatility? While I think they could help during “normal” periods, they would not fundamentally eliminate the incentives for international investors to be “first out the door” during crises. For households and the corporate sector, bankruptcy systems provide rules for the timely recovery of resources, and thus help prevent defaults from becoming overly disruptive. But when a shock hits an emerging market, the incentives to be first out the door are magnified by the perception that emerging market bankruptcies are slow, biased against creditors, and, in some cases, corrupt. The situation for emerging market sovereigns is even starker: there are no bankruptcy systems. As a result, when a country fails to service its debt, it must either restructure or default. In my view, while Williamson’s policy recommendations would help mitigate the incentive to be first out the door, they do not fully make up for the absence of international bankruptcy procedures.

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NOW that developed countries and international financial institutions have committed themselves to writing off the debt of highly indebted poor countries, the challenge will be to convert these resources into actual growth and faster progress toward the Millennium Development Goals. While for some it may seem that the war against poverty can be won simply by getting rich countries to provide more debt relief and aid, the view of experts—including those behind recent reports by the U.K. Commission for Africa and the Millennium Project—is that this is just one of the necessary ingredients. It’s early days yet in the campaign to make poverty history. If it’s to succeed, we have to recognize the failures of the past as well as be open-minded about the solutions for the future. And the first thing to recognize is the chequered history of aid.

Aid and growth

The best way to get the poor in low-income countries out of poverty is to strengthen economic growth in those countries. To the layperson, this may mean just sending these countries more aid. Yet one point about which there is general agreement among economists is that there is little evidence of a robust unconditional effect of aid on growth. For instance, if aid tends to go to countries that are doing badly, you would get aid and growth being negatively correlated even though aid doesn’t cause poor growth: the direction of causation is the reverse. This is why economists use a technique called instrumental variables analysis to tell causality from simple correlation. In recent papers that I have written with Arvind Subramanian of the IMF’s Research Department, we describe how we found a negative correlation between aid and growth when we didn’t use instrumental variables, but how this essentially disappeared once we used the technique (Rajan and Subramanian, 2005 a and b). This means that aid skeptics may have been mistaken in viewing negative correlations found in the past as supporting their view. But unfortunately, we don’t find a robust, significant positive correlation either.

Does this mean that aid can’t, in any circumstances, boost growth? Of course not! The layperson’s thinking does, of course, have some significant basis. Poor countries are short of resources and ought to be able to put aid inflows to good use. There are case studies of countries that have grown using aid, and specific aid projects that have helped the poor enormously. What we economists haven’t identified is a reliable set of economic circumstances in which we can say that aid has helped countries grow. And this isn’t for want of trying.

For example, an influential study suggested that aid leads to growth, but only in countries that have good governance (Burnside and Dollar, 2000). This certainly
seemed a very reasonable conclusion—a necessary condition for aid to help growth is obviously that aid receipts shouldn’t be spirited away to Swiss bank accounts. Unfortunately, however, it doesn’t seem to be a sufficient condition for aid to help growth, since follow-up studies suggest the finding isn’t robust (Easterly, Levine, and Roodman, 2004). It would appear that other levers are needed in addition to reasonable governance for aid to be effective.

A recent study (Clemens, Radelet, and Bhavnani, 2004) takes another crack at parsing the data, working from the assumption that not all aid is alike in its impact on growth. Again, the rationale is plausible. Why, for instance, should we expect humanitarian aid to result in growth, or why should we expect aid devoted to education (children are a long-term project if ever there was one) to produce growth in the short run? The study indeed shows that aid likely to have a short-term economic impact (for instance, aid used to build roads or support agriculture directly) is positively correlated with short-term growth. Here again, however, I’m not fully persuaded. The authors of this study argue that the reason to focus on short-impact aid is because the literature focuses on country growth rates over four-year periods. So I presume it follows that if one were to depart from the literature and look at long-run growth (say growth over decades, which is what we really care about), economic aid (as contrasted with, say, humanitarian aid) cumulated during the period should have a discernible effect on growth (and there would be no need to separate out short-impact aid from long-impact aid). My work with Subramanian suggests that economic aid doesn’t have a robust positive correlation with long-run growth.

Despite my own convictions about what the past tells us, I will acknowledge that the debate about aid effectiveness is one where little is settled. Unfortunately, further cross-country research along existing lines may not yield credible answers. We can continue trying to find some variable that will select out those countries that have received aid and also grown (or attempt to find some form of aid that is positively correlated with growth). But what do we conclude once we do that? Put another way, when the same data are pored over many times, there is a danger we will find patterns that are there by accident. This is why many economists have become skeptical that cross-country studies can tell us much more.

Of course, the layperson would despair of the ability of further econometric analysis to shed light on the debate long before the economist. It should, however, be of concern to the layperson that the best example we have of aid working (as contrasted with, say, humanitarian aid) cumulated during the period (as contrasted with, say, humanitarian aid) cumulated during the period is the Marshall Plan, whereby the ravaged countries of postwar Western Europe were returned to the ranks of the rich. The reason it worked so well might be that these countries’ institutions, including the education of their people, were probably capable of sustaining much higher per capita GDP than their postwar low. Perhaps this is why one might see a country emerging from conflict experience a substantial period of catch-up growth, when aid is very effective—Mozambique or Uganda might be more recent examples. Nevertheless, it should be sobering that the canonical recent example of a country clawing itself out of poverty into the ranks of the rich is Korea. Korea was indeed ravaged by war, but its spectacular growth started approximately when aid inflows tapered off.

Dodging “Dutch disease”

According to some, there is a better way—to focus on what we know works. Specifically, funding should support micro-interventions or programs, validated through evaluations and experimentation, that might be very helpful, say, in furthering education and health care, which undoubtedly lead to growth. Here, we have learned a lot from work by Abhijit Banerjee of the Massachusetts Institute of Technology, Michael Kremer at Harvard, and their students, as well as from the World Bank, including its World Development Report 2004.

We know that providing services to the poor isn’t just about money. One can build spanking new schools and pay teachers a good wage, yet they may not come in to teach. One can provide free drugs to the hospitals, intended for the poor, but the druggist may simply sell them on the black market. This isn’t to say that schools and hospitals aren’t necessary, but bricks and mortar are often the easy part. Policymakers also need to create the right incentives for the service provider and the poor client, as well as the right allocation of power and information between them to ensure that reasonable quality services are provided. And we know that the law of unintended consequences is always at work. This means that few programs ever operate as the designers intended, so we need abundant experimentation, frequent monitoring and evaluation, and a sharing of best practices so that these targeted interventions can have their intended effect.

Unfortunately, I’m not sure that even if each micro-intervention works well by itself, they will all work well together. Interventions could affect each other and get in each other’s way or vie for the same resources. They could also have adverse spillover effects on the rest of the economy.

The last isn’t just a possibility. Suppose a lot of aid flows in to support interventions in education, health care, and other social services. The recipient country quickly hires many educated workers as teachers, clerks, nurses, foremen (to build the schools), engineers, and government and aid
How about humanitarian aid?

Does this cautious approach toward aid in general mean that the world should hesitate to give humanitarian aid? Absolutely not! But the form of the aid matters. In the midst of a humanitarian disaster, one should concentrate on getting enough relief in kind to the affected area if local production is typically not possible (for example, because the failure of local crops is the proximate cause of the humanitarian disaster). Aid sent in the form of cash may, however, be better if supplies are available but the distressed population doesn’t have the buying power. Aid could then create more local jobs. Also, when the immediate emergency is over, donors should be careful that additional aid doesn’t hamper incentives for local production—that, for example, donated secondhand clothes don’t kill the business of local tailors.

And every so often, donors are confronted with the Good Samaritan’s dilemma. An uncaring local government siphons off a fraction of the humanitarian aid in return for allowing the aid to get through to the starving people. While the aid reduces the immediate suffering of the people, it also entrenches the government, perpetuating the people’s long-term suffering. There are no easy solutions to this dilemma.

administrators. Because well educated people will be in high demand, their wages will tend to rise and may well go up rapidly. In turn, factories will have to escalate the wages they pay to managers, engineers, and supervisors. Now factories that produce for the domestic market and don’t face competition can pass on their higher costs. But factories that export can’t, so they will cut down on operations and even start shutting down. This is one example of a phenomenon called Dutch disease, which makes aid recipients less competitive. Subramanian and I show that in countries that received more aid in the 1980s and 1990s, the export-oriented, labor-intensive industries not only grew more slowly than other industries—suggesting that aid did in fact create Dutch disease—but the manufacturing sector as a whole also grew more slowly. Again it’s sobering to think that by constraining the growth of manufacturing, aid inflows may have prevented recipient countries from taking the path to growth followed first by the East Asian tigers and now by China.

That said, Dutch disease is not a terminal condition. It can be mitigated through sensible policies. But to do so, one must first acknowledge its existence and its pernicious effects. The same goes for other possible diseases caused by aid.

There is hope

To ignore the past, or to read only rosy lessons from it, is to condemn oneself to relive it. While it would be churlish to deny that many poor countries have made tremendous progress in creating the conditions for sustained growth, it doesn’t serve the citizens of poor countries either if we say that all the problems of the past are well and truly in the past. While no one has the “magic bullet” for growth, there are some things that do seem important. These include sensible macroeconomic management, with fiscal discipline, moderate inflation, and a reasonably competitive exchange rate; laws and policies that create an environment conducive to private sector activity with low transaction costs; and an economy open for international trade. In addition, investments in health and education—which create a population that not only lives a better life but also sees opportunities in growth and competition—ought to be encouraged.

One way rich countries and international financial institutions can help is by making policies that broadly meet these requirements an essential condition for aid. They should, however, resist micromanaging and overlaying broad economic conditionality with too many detailed economic prescriptions, or with social and political conditionality. Once a country has the necessary broad environment in place, it should have the freedom to chart its own path. After all, the failure of past grand theories of growth should make us wary of becoming overly prescriptive.

Rich countries can also help by reducing the impediments they place in the way of poor country exports, and by coaxing these countries to lower their own trade barriers, including barriers to other poor countries. They can spend more to foster research on drugs and agricultural technologies that would benefit the poorest countries. They can be more active in ensuring that their companies and officials don’t grease the wheels of corruption in poor countries (see Birdsall, Rodrik, and Subramanian, 2005, for other suggestions). And they should never hesitate to give humanitarian aid in the face of a disaster (see box).

Let us draw hope from the willingness of the outside world to provide more, and better, aid. Ultimately, though, poor countries hold their future in their own hands. It’s only through their own will and actions that the good intentions of the outside world can be used to truly make poverty history.

References:

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Sources: Central Bank of Peru and World Bank World Development Indicators.
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