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Why Does Latin America Underperform?

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Why Does Latin America Underperform?

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Table of Contents

Figures

Tables

Foreword

The Group of Thirty (G30) presents its latest publication, *Why Does Latin America Underperform?* Prepared by the G30 Working Group on Latin America, the report examines the multiple pressures on economies, governments, and central banks in the Latin American region as they exit the COVID-19 global pandemic.

The report analyzes Latin American countries economic performance against a comparable cohort of nations outside the region, demonstrating that Latin America averages slower growth and lower productivity. Economic theory suggests poor countries should gradually converge to the income levels of advanced nations, as has been experienced in East Asia. However, Latin America and the Caribbean continue to lag against their peers.

This report seeks to illuminate the various interlinked factors that may contribute to the continued poor performance among the countries studied. It identifies both the sources of Latin America's stagnation and the main distortions and constraints hindering economic development and points to potential solutions going forward and ways to overcome ongoing challenges.

Crafted by a Working Group with learned experience in what it takes to run governments, financial ministries, central banks, and international institutions, we believe the report will add meaningfully to the necessary debate on the economic outlook for the region. This report follows in the G30 tradition of focusing on the hard questions, offering frank assessments, and delivering advice to the public and private sector financial and economic communities across the globe.

On behalf of the G30, we extend our thanks to Arminio Fraga and Guillermo Ortiz for their astute leadership of the Working Group on Latin America, and to the members of the Working Group for their dedication and efforts.

We are also grateful to the Project Director, Andrés Velasco, for bringing his extensive knowledge and expertise to the task of drafting the report.

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We extend our thanks to Project Director Andrés Velasco for his careful drafting and support. We also thank the team of research assistants from the School of Public Policy at the London School of Economics, including Renzo Giraudo, Joaquín Marandino, Catalina Montes, and Mónica Palomino.

The coordination of this project and many aspects of project management, Working Group logistics, and report production were centered at the G30 offices in Washington, D.C. This project could not have been completed without the efforts of our editor, Diane Stamm, and the work of Executive Director, Stuart Mackintosh, and his team, including Desiree Maruca, Maria Cueto Velez, and Annika Hemdal. We are grateful to them all.

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Abbreviations

COVID-19	coronavirus disease 2019
GDP	gross domestic product
HDI	Human Development Index
IMF	International Monetary Fund
Latam	Latin America
TFP	total factor productivity
V-Dem	Varieties of Democracy

Country Abbreviations

ARG	Argentina
BGR	Bulgaria
BRA	Brazil
CAN	Canada
CHL	Chile
COL	Colombia
CRI	Costa Rica
CUB	Cuba
CZE	Czech Republic
DOM	Dominican Republic
ECU	Ecuador
EGY	Egypt
ESP	Spain
FRA	France
GBR	United Kingdom
GTM	Guatemala
HND	Honduras
HTI	Haiti
HUN	Hungary
IDN	India
ITA	Italy
JAM	Jamaica
JPN	Japan
MEX	Mexico
MYS	Malaysia
NIC	Nicaragua
PAN	Panama
PER	Peru
PHL	Philippines
POL	Poland
PRY	Paraguay
ROU	Romania
SLV	El Salvador
THA	Thailand
TUR	Turkey
URY	Uruguay
USA	United States of America
VEN	Venezuela
ZAF	South Africa

Executive Summary

This paper provides an overview and analysis of why Latin America is failing to converge to the income levels of advanced economies – that is, why it continues to underperform. The problem has worsened recently because of a succession of recent global shocks: the COVID-19 pandemic, the return of inflation, higher interest rates, and slowing growth. To address this issue, instead of suggesting a litany of institutional reforms that are unlikely to be implemented in the current political environment, the paper highlights several policy steps to take going forward.

* * *

The COVID-19 pandemic hit Latin America especially hard. Poorer and less developed nations had better health outcomes than the region. The economic shocks were many and large but, unlike previous crises, Latin America was able to implement a strong countercyclical monetary response, and many of the countries also deployed significant fiscal stimulus programs. The combination of the end of lockdowns, worldwide recovery, and expansionary fiscal and monetary conditions allowed in 2021 for a rapid but short-lived output recovery. Last year, the region experienced a slowdown, and prospects for 2023 and beyond suggest a return to unimpressive trend growth.

The return of inflation and, as a consequence, rising global interest rates, further complicates the outlook for Latin America. The region's central banks were first responders, tightening monetary policy early and vigorously. But inflation reduction will come at the cost of slower economic growth. Elevated debt levels and a higher cost of carrying that debt pose a challenge for both fiscal sustainability and financial stability. Despite these dangers, no Latin American nation has lost market access since the COVID-19 crisis, nor has a domestic banking or financial crisis erupted anywhere. Improvements in domestic financial supervision and the macro policy framework are paying off in most countries.

* * *

Latin America's malaise is not of recent origin. Trend growth has long been weak and seems to have weakened further with the pandemic. A growth accounting exercise for Latin America shows that capital accumulation and productivity improvements in the last three decades contributed little or nothing to growth. Labor force growth, including an increase in the participation of women, has been the main driver of higher output. Investment in human capital (that is, more years of schooling) has also contributed.

The paper compares the region's performance in a set of indicators to that of a group of extraregional peers of similar level of income per capita. Since the 1970s, economic growth in the peer group has been double that of

Latin America. Years of schooling show important gains in both groups, but the peers have higher levels of investment and faster productivity growth. Lower investment in Latin America can be attributed to several factors, including weak productivity, low domestic savings, growing political uncertainty, and a recent deterioration of the investment environment.

Productivity growth has performed dismally, with a gradual but sustained declining path since the mid-1990s. There has been much research on why this is so, and most explanations point to two sources of resource misallocation, each with different policy implications. The first is misallocation within and among firms within a sector. It highlights the significant productivity gaps between small and large firms, between formal and informal businesses, and between manufacturing and services firms. These gaps persist because distortions hinder a reallocation of resources from low-productivity to high-productivity firms. Badly designed policies and regulations exacerbate the problem by causing resources to flow to less productive firms.

The second explanation focuses on misallocation across sectors, particularly between exportable goods and the rest. Countries with more diversified export baskets can sustain faster growth by reallocating resources toward higher-return sectors. Evidence shows that Latin American countries have a less diversified export structure than their peers, which may lower their growth rates. The economic complexity indicator (a measure of how diversified and commonly produced a country's weighted average export basket is) has since 2000 either stagnated or declined in most Latin American nations.

In addition, large internal productivity differences affect the performance of countries like Brazil and Mexico, and convergence among regions remains limited. This can be attributed to poor policy (especially regarding investment in infrastructure), but productivity traps may also be hindering regional development.

* * *

While Latin American countries share some challenges, the situation does not allow for one-size-fits-all explanations. Four distinct low-growth syndromes characterize Latin American countries.

The first syndrome pertains to countries with endemic macro instability. Argentina, Ecuador, and Venezuela have suffered from hyperinflation episodes, volatile growth, and debt sustainability problems. These cases highlight the importance of macro stability for sustained growth.

The second syndrome includes countries such as Chile, Colombia, Peru, and Uruguay which, despite achieving macroeconomic stability, have over time experienced a decline in growth. Market and government failures, as well as a scarcity of high-return private investment projects, have plausibly contributed to the sharp growth slowdown experienced by these countries.

The third syndrome pertains to Mexico, which has experienced a growth paradox. The country has enjoyed over two decades of macroeconomic stability and has developed a sophisticated manufacturing sector, yet growth has stagnated. Productivity misallocation, regional disparities, narcoviolence, and institutional deterioration are some of the key deterrents to growth.

The fourth syndrome pertains to Brazil, which had strong growth prior to the 1980s but has displayed mediocre growth performance ever since. Endemic budget deficits, high real interest rates, and low national savings are major constraints on sustained growth. Political challenges, including inequality, populism, and polarization, hinder the necessary fiscal adjustments. The result is a persistent cycle of slow growth, volatility, and uncertainty.

* * *

Beyond economic growth, the report also addresses issues such as inequality, citizen discontent, and the rise of populism. Until the pandemic, income inequality was declining as a result of the reduction in the wage skill premium and increased government transfers. Human development indicators, including health and education, showed improvements in Latin America, though at a slightly slower pace than in the peer group.

A key question is why, despite the social improvements of the last few decades, Latin America's population seems more dissatisfied than before. One factor may be the growing perception that inequalities stem from spurious factors such as corruption and state capture. This is part of the so-called de Tocqueville paradox: as social conditions improve, tolerance for inequality drops, and therefore frustration can grow more quickly.

The region's political economy remains problematic. Recent events in several countries, including attempts to dissolve Congress, convictions of high-ranking officials, and attacks on government buildings, have raised concerns about the future of democracy in Latin America. Another concern is the low and declining level of citizen trust—both interpersonal trust and trust in institutions. Latin America may be trapped in an unhealthy equilibrium, where lack of trust hinders the performance of government institutions, and poor performance in turn explains low trust.

Latin America's political systems—a combination of presidential regimes and proportional electoral systems—make it difficult for the executive to build a parliamentary majority. Reforms aimed at increasing representation have unintentionally resulted in the proliferation of small, unrepresentative parties and weakened party discipline, which in turn makes securing parliamentary support for government initiatives even more difficult.

Taken together, these factors constitute a governance deficit in the region. Addressing this deficit will require deep and ambitious political reform.

Introduction

Economic theory suggests that poor countries should gradually converge to the income levels of advanced nations. That has happened in East Asia, but not in Latin America and the Caribbean. In the last six decades, only a few countries in the region have narrowed the gap between their per capita income and that of the United States. Slow and even negative productivity growth, and investment rates far below those of peers in Eastern Europe and Asia, are key parts of the problem.

Latin America's economic growth has long disappointed, but the problem has become particularly acute since the end of the commodity boom nearly a decade ago, with once-fast-growing economies such as Chile and Peru slowing significantly, and large countries such as Argentina, Brazil, and Mexico continuing their mediocre long-term growth performance. Even Panama, once the regional growth star, grew little in 2019, suffered a double-digit recession in 2020, recovered strongly in 2021–22, but is now expected to experience much weaker growth going forward. Indeed, most economies recovered quickly in 2021 as COVID-19-motivated lockdowns ended, but forecasts now show a landscape of tepid investment and growth in Latin America stretching far into the future.

Economic and social problems have been compounded by Latin America's troubling performance during the pandemic. Ten of the 40 countries with the most deaths per capita are in Latin America. Economies saw massive drops in activity, and schools remained closed longer than in most other regions of the world, with the consequent loss in human capital. Both poverty and income inequality increased.

All of this happened even though in this crisis, unlike previous crises, most Latin American governments did not lose market access and were able to borrow copiously to finance transfers to households and other kinds of emergency expenditures. Peru stands as a symbol of this contradiction: in 2020, it increased government expenditure by nearly 5 percentage points of GDP, ran a budget deficit of nearly 7 percentage points of GDP, and nonetheless persistently led the world in pandemic-caused deaths per capita.

It is tempting to argue that this mediocre performance was caused by special factors such as the prevalence of informal jobs, the particular structure of Latin American households (with many generations often living under the same roof), and weaknesses of the region's health infrastructure. But these are not satisfying explanations, since many developing countries in Africa and Asia share those same characteristics and nonetheless performed better.

Even more recently, the inflation spike, rising world interest rates, and financial market turmoil have brought new challenges. Latin American countries followed the United States and Europe in reaching 12-month inflation rates of 10 percent or more, and in most countries exchange rates depreciated sharply in response to a surging dollar. Latin American central banks have shown remarkable willingness to tighten policy to bring inflation under control. But most countries used whatever fiscal space they had during the pandemic, so they would be hard-pressed to use fiscal policy to manage aggregate demand in the event of a world recession.

The performance of the region regarding income distribution has also been uneven. This traditionally very unequal region made important distributional gains during the commodity boom. As economies grew, wages rose, and governments used the additional revenues to increase cash transfers and welfare expenditures. But those gains ended once the boom ended and then were partially undone by the pandemic. In the post-pandemic world, with slowing growth, higher inflation, increased public debt, and overstretched public expenditures, new distributional gains will be harder than ever to attain.

The political context in Latin America is as important as the economic context. Latin America was never a model of democratic governance, but in the last decade of the 20th century and the first decade of the 21st, democracy seemed well entrenched across the region. Surely, liberal protections for minorities, democratic accountability, and the rule of law still had room to improve in a number of nations, but the widespread emergence of democratic regimes represented a massive gain in terms of liberty and human welfare, especially when compared with the dictatorships and various forms of autocratic regimes that had preceded them.

Now some of this democratic progress is being undone. Democracy has disappeared in Venezuela and Nicaragua and remains under severe threat in El Salvador and other nations of the hemisphere. Contested legislation that would weaken Mexico's Federal Electoral Institute has prompted concerns about the credibility of future elections in that country.

In Peru, a succession of short-lived governments has placed democracy under strain, while in other nations such as Brazil, Chile, and Colombia, political polarization and the fragmentation of parliaments into myriad parties—some of them of dubious representativeness—have rendered governance a great deal more challenging. Throughout the region, citizens tell pollsters of growing frustration and disappointment with the performance of democracy. Latin America's political institutions increasingly look like they need an overhaul.

At the same time, democracy has proven more resilient than pessimists expected. In Brazil, an unprecedented attack on federal buildings in Brasilia, reminiscent of the January 6 takeover of Congress in Washington, D.C., did not cause a breakdown of democratic government. In Peru, a president who attempted to close parliament and assumed dictatorial powers was summarily impeached by that very same parliament. In Mexico, an independent career judge was elected to the presidency of the Supreme Court, which has now annulled legislation designed to weaken the electoral authority. Chile experienced violent street protests in late 2019, but managed to defuse the agitation by launching a process of constitutional reform. It now seems likely that by late 2023, Chile will have a new constitution, written by democratic means.

This paper seeks to contribute to identifying both the sources of Latin America's malaise and possible ways forward. In doing so, we try to avoid two common pitfalls. The first pitfall is the temptation of monocausal explanations, which attribute all of the region's problems to a single source, whether it be colonial origins, corruption, or inequality. Aside from being empirically flawed, it is unlikely that a complex situation has a single source, and such an approach can have misleading policy implications: invest more, end corruption, or reduce inequality and the region will sooner or later come to resemble Denmark. Silver bullets have obvious political appeal, but the history of Latin America is littered with the failed experiences of leaders who promised to fix all problems by attacking a single cause, and in the end fixed very little.

The second pitfall is the temptation of long shopping lists. Precisely because the situation is complex, and reforms with a narrow focus have yielded little, it is tempting to go to the other extreme and conclude that little or no substantial progress can be achieved until a long list of key institutions have been reinvented. The practical implication is that nations and their leaders are confronted with an endless array of challenging institutional reforms—reengineer schools, reform the judiciary, revamp the regulatory apparatus, streamline the state bureaucracy, open up every last corner of the economy to global competition, and so on—that must be completed before growth can restart and social inclusion can advance. Democratic leaders facing fragmented parliaments and short terms in office are unlikely to achieve such tasks.

The alternative to these two common pitfalls is to engage in a process of diagnostics like that employed by clinicians. A doctor starts with the symptoms, uses them to make educated guesses about the malady the patient might be suffering, and then tackles its key causes with the medicine most likely to address those symptoms. That is what we try to accomplish in this paper. In the policy realm, the key is a clear sense of priorities and the smart sequencing of actions so as to create a virtuous circle of development.

* * *

The rest of this paper is structured as follows. Section 1 describes recent developments involving both the policy response to the pandemic and the economic recovery that followed that policy response. Section 2 provides a bird's-eye view of long-term economic trends in the region regarding growth, productivity, and export diversification. Building on the previous analysis, Section 3 identifies four "syndromes" that characterize mediocre social and economic performance in the region. The main message is that the growth deficit is substantial and widespread, but the binding constraints that hold back growth vary depending on which syndrome is affecting the country in question.

Section 4 covers trends in income distribution. An important point is that distribution became less skewed in the first two decades of this century, due to both economic growth (and hence rising wages) and more redistributive government policies. Sadly, the pandemic seems to have reversed that trend. Section 5 brings politics into the center of the analysis and argues that some of the constraints on growth are political economy in nature. One important issue is the design (mis-design, really) of political institutions in the region. Another one is low and falling levels of trust, both interpersonal and institutional. This may well be part of a vicious circle in which low trust hinders governmental performance and the quality of public services provided, which in turn reduces institutional trust even further. Section 6 suggests some conclusions.

Pandemic response and recovery

Public health response and outcomes

The effects of the pandemic on Latin America were severe. By the end of 2021, 10 of the 40 countries across the globe with the most COVID-19 deaths per capita were in Latin America (table 1). Of these countries, Peru ranked first, with the most deaths, and Argentina and Brazil were in the top 20.[1] The international comparison would look even worse if the cutoff date was December 2020, before widespread vaccination.

Why did the region underperform? Deficient choices at the onset of the pandemic are one explanation. The two largest countries in the region, Brazil and Mexico, delayed mobility restrictions, only to reverse course suddenly and impose severe quarantines. But even in the countries that acted early, containment measures were ineffective at reducing the number of COVID-19 cases. Argentina and Peru, which locked down hard, and Chile and Colombia, which followed a more flexible approach, suffered similarly mediocre health outcomes.

What other factors made a difference? The starting point was not good: there were many people with pre-existing health problems, and the prevalence of certain living arrangements, such as several generations living under the same roof, facilitated contagion. Widespread labor market informality also made lockdowns difficult to enforce; a street seller who does not work will have no income. There is also a high incidence of face-to-face jobs, such as retail, and a scarcity of remote work opportunities due to poor connectivity and digital literacy. In addition, health systems were unprepared despite early lockdowns that postponed the contagion peak.

These factors help explain the common outcomes across dissimilar strategies. Indeed, the performance of Uruguay, perhaps the best (or the least bad) performer in the region, plausibly reflects a combination of universal health access, greater labor formality and social protection, relatively better state capacity, and sensible leadership.

All things considered, the underperformance of Latin America revealed pervasive shortcomings in state capacity, extending beyond weak health infrastructure. A few countries did not have the necessary information to identify poor households and provide them with financial help. Other countries had the information but had to provide the help via a written check instead of an electronic transfer. The resulting crowds outside of bank branches contributed to the spread of the virus. In Latin America, classes and educational activities remained suspended long after schools restarted in Europe and Asia, due to unresolved logistical problems and conflicts between governments

1 This was a dismal public health performance, for at least two reasons. First, the region accounts for only 17 percent of the countries in the world, so it was over-represented among the worst performers. Second, per capita income alone does not seem to explain this performance. Poorer and less developed countries in South Asia, Africa, and other regions of the world performed better on COVID-19-related morbidity indicators than upper middle-income Latin American nations.

Table 1. COVID-19 deaths per million as of December 31, 2021

COUNTRY	DEATHS PER MILLION	COUNTRY	DEATHS PER MILLION
Peru	**5,953**	Ukraine	2,571
Bulgaria	4,564	**Colombia**	**2,505**
Bosnia and Herzegovina	4,157	Latvia	2,469
Hungary	3,931	**Paraguay**	**2,452**
Montenegro	3,845	United States	2,441
North Macedonia	3,802	Poland	2,435
Georgia	3,686	Belgium	2,431
Czech Republic	3,443	**Mexico**	**2,348**
Moldova	3,139	Italy	2,327
Croatia	3,111	Russia	2,092
Gibraltar	3,060	French Polynesia	2,076
Romania	2,989	Tunisia	2,069
San Marino	2,968	Greece	2,002
Slovakia	2,948	**Chile**	**1,995**
Brazil	**2,876**	**Suriname**	**1,924**
Armenia	2,867	Austria	1,881
Lithuania	2,690	Spain	1,880
Slovenia	2,637	**Trinidad and Tobago**	**1,874**
United Kingdom	2,628	**Ecuador**	**1,871**
Argentina	**2,575**	Serbia	1,850

Source: Our World in Data.

and teachers' unions. This disruption of education and schooling had implications for the employability of individuals particularly for low-income households.

The nature of labor markets was another structural weakness. Dual labor markets disproportionately expose low-income workers to income shocks. On average, about half of workers are informal wage earners or self-employed without a university degree (table 2); in Ecuador, El Salvador, and Peru, more than two-thirds of workers are informal. Many had to be supported through cash transfers rather than employment programs such as wage subsidies and furlough schemes, and the cash compensated only part of lost income.

Table 2. Informal employment rate
Aged 15 and above, %

COUNTRY	RATE	YEAR
Ecuador	68.6	2021
El Salvador	68.5	2020
Peru	68.4	2021
Colombia	63.2	2021
Jamaica	58.0	2020
Mexico	57.1	2021
Panama	55.7	2021
Dominican Republic	54.5	2020
Argentina	46.8	2020
Costa Rica	40.8	2021
Brazil	39.4	2021
Chile	27.1	2021
Uruguay	21.9	2020

Source: International Labour Organization.

Economic shocks and outcomes

The economic damage to Latin American countries was substantial because they suffered not one but five simultaneous blows. In addition to the initial health shock, commodity prices dropped, export volumes significantly contracted, remittance and tourism revenues were lost, and there was unprecedented capital outflow early in the crisis. Demand contracted, liquidity diminished, and countless businesses of all sizes ran out of cash and were forced to shut down.

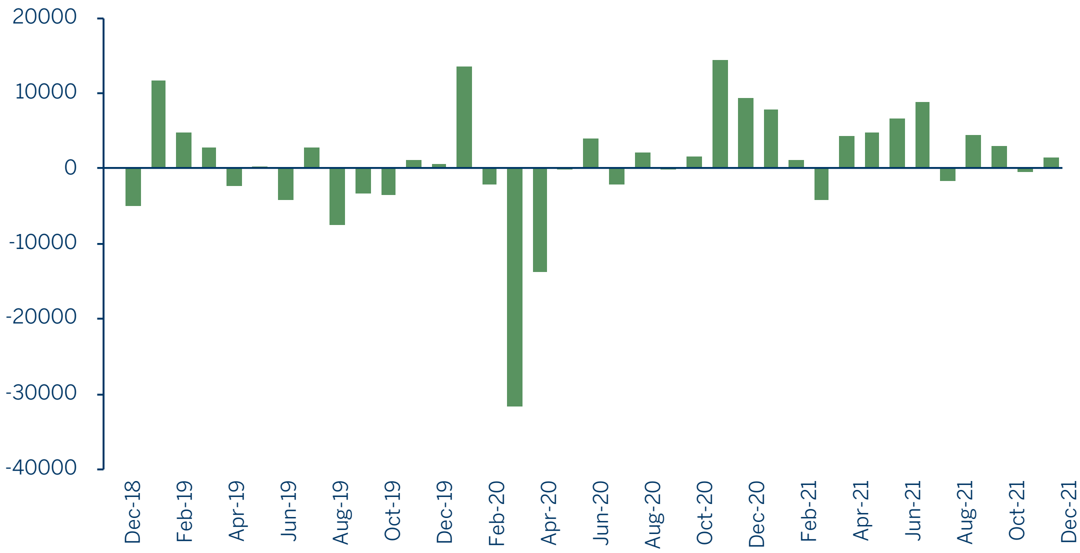
Fortunately, the early sudden stop and reversal in capital flows was intense but short-lived (figure 1). By the second half of 2020, capital outflows had ceased (though earlier outflows did not necessarily reverse themselves). Later on, and in contrast to previous crisis episodes, they retained access to international capital markets.[2]

The 2020 output contraction was massive (table 3). Among the five largest economies in the region, Peru experienced the biggest drop, despite a substantial fiscal and monetary policy response. Predictably, small tourism-dependent economies in the Caribbean and Central America were particularly hard-hit, experiencing an average contraction of 15.7 percent.

A striking feature of the COVID-19 crisis was the extent to which many Latin American countries were able to mount strong countercyclical macroeconomic responses to the shock. During the global financial crisis a dozen years earlier, only Brazil and Chile enjoyed sufficient market confidence to be able to cut interest rates and embark on a large fiscal stimulus package. Other countries did not, either because they did not have market access to finance a larger fiscal deficit, or because they feared the impact on the exchange rate if they cut interest rates too far, too fast.

In 2020, things were very different. The countries with flexible exchange rates and inflation targeting regimes—among them Brazil, Chile, Colombia, Mexico, Peru, and Uruguay—were able to cut rates fast and engage in a number of unconventional monetary policies without an adverse market reaction (figure 2). At the same time, the International Monetary Fund (IMF) estimates that in Latin America the size of the COVID-19-related fiscal stimulus (including loans and deferred taxes, not just additional state expenditure) was 7 percent of GDP, and in four nations (Bolivia, Brazil, Chile, and Peru) it amounted to 10 percent or more of GDP. One exception to this trend, as can be seen in figure 3, was Mexico,

Figure 1. Capital flows to Brazil, Chile, and Mexico, Dec-18 to Dec-21
US$ million



Source: OECD Monthly Capital Flow Dataset.

2 One important difference this time around was the role of China as a lender (see Horn, Reinhart, and Trebesch 2019).

Table 3. Real GDP growth, 2020–24

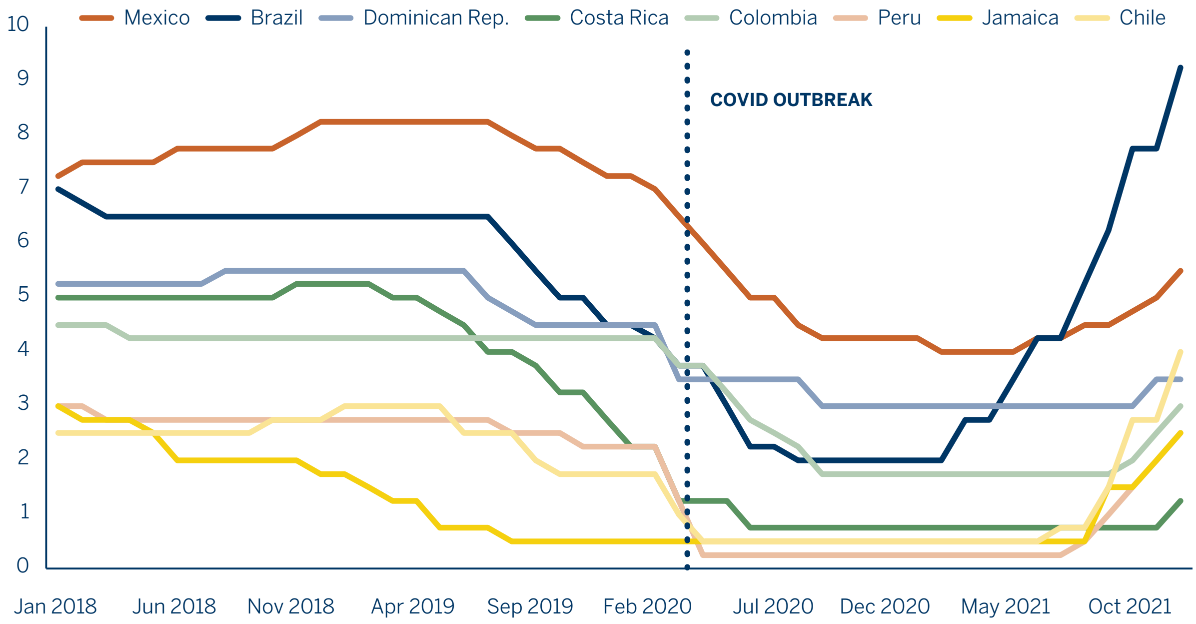
Year-over-year (% change)

	2020	2021	2022	2023 PROJ.	2024 PROJ.
Latin America and the Caribbean (LAC)	**-7.0**	**7**	**4**	**1.6**	**2.2**
LAC excluding Venezuela	-6.6	6.7	3.7	1.7	2.2
South America	-6.6	7.5	3.9	1.0	1.9
CAPDR	-7.1	11	5.3	3.8	3.8
Caribbean					
Tourism Dependent	-15.7	7.8	7.2	3.2	2.4
Other	1.3	2.5	17.2	13.6	20.0
Of which: Commodity Exporters	4.0	4.7	25.5	18.7	25.8
LA5	**-6.2**	**6.5**	**3.4**	**1.2**	**1.7**
Brazil	-3.9	5.0	2.9	0.9	1.5
Chile	-6.1	11.7	2.4	-1.0	1.9
Colombia	-7.0	11.0	7.5	1.0	1.9
Mexico	-8.1	4.7	3.1	1.8	1.6
Peru	-11.0	13.6	2.7	2.4	3.0

Source: IMF *World Economic Outlook April 2023*.
Note: CAPDR = Central America, Panama, and the Dominican Republic; LA5 = the 5 largest Latin American economies.

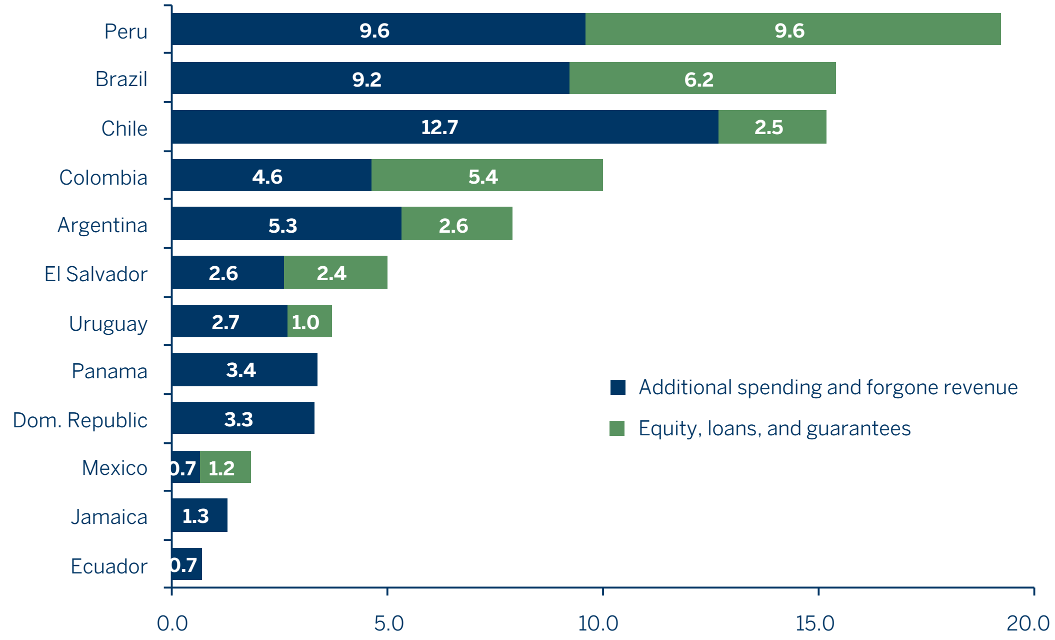
Figure 2. Monthly policy interest rate, Jan-18 to Dec-21

Percent per annum



Source: IMF.

Figure 3. Fiscal measures in response to the COVID-19 pandemic
Percent of 2020 GDP



Source: IMF.
Note: These figures include fiscal measures announced or taken between January 2020 and September 27, 2021. Data on equity, loans, and guarantees are not available for Costa Rica, the Dominican Republic, Ecuador, Jamaica, or Panama.

which, given ongoing market access and relatively low spreads, could have spent more but chose not to.

Whether these fiscal efforts were too large or not large enough depends on the country in question and the standard of comparison. Also, according to the IMF, in 2020, advanced economies deployed an array of discretionary fiscal measures amounting to 20 percent of GDP, on average. Compared to that figure, the Latin American response seems mild, an impression that is reinforced by the fact that during 2020, the current account deficits of countries in the region narrowed or turned into surpluses, while theory suggested they should have widened in response to a transitory shock. This current account performance (see table 4) suggests that fiscal packages were insufficient to offset the private expenditure drop, both in consumption and investment.

The fiscal response, in contrast, was larger than in any other crisis in modern history. In 2021, the combination of loose fiscal and monetary policies managed to stimulate consumption in several economies. In addition, two of them—Peru and Chile—allowed citizens to make withdrawals from their private retirement accounts. The amounts involved were very large—more than US$40 billion in Chile, or 14 percent of GDP. That much liquidity in the hands of consumers gave rise to a consumption boom, with the current account deteriorating at the same time.

The combination of a gradual end of lockdowns, a worldwide recovery, and expansionary monetary and fiscal conditions at home, gave rise to a fast output recovery in 2021, with the headline GDP figure rising at double-digit rates in Chile, Colombia, and Peru (see table 3). By the end of 2021, most large economies in the region—except Mexico—had recovered their pre-COVID-19 levels of economic activity.

The recovery was short-lived, however. The IMF estimates the region grew only 3.5 percent in 2022, with only Colombia among the larger economies continuing to expand at a fast clip. Perspectives are even dimmer for 2023, with growth at only 1.7 percent, half the rate of the previous year. One factor that explains the sluggish economy is the slow recovery of investment, affected by global and local political uncertainty. Another factor is a challenging external environment.

Table 4. Current account balance, 2016–22
Percent of GDP

	2016	2017	2018	2019	2020	2021	2022 PROJ.
Argentina	-2.7	-4.8	-5.2	-0.8	0.8	1.4	-0.7
Brazil	-1.7	-1.2	-2.9	-3.6	-1.9	-2.8	-2.9
Chile	-2.6	-2.8	-4.5	-5.2	-1.9	-7.3	-9.0
Colombia	-4.5	-3.2	-4.2	-4.6	-3.5	-5.6	-6.2
Costa Rica	-2.1	-3.6	-3.0	-1.3	-1.0	-3.3	-4.3
Dominican Republic	-1.1	-0.2	-1.5	-1.3	-1.7	-2.8	-5.8
Ecuador	1.1	-0.2	-1.2	-0.1	2.7	2.9	2.2
El Salvador	-2.3	-1.9	-3.3	-0.4	0.8	-5.1	-8.3
Jamaica	-0.3	-2.7	-1.6	-2.2	-0.4	0.7	-3.2
Mexico	-2.4	-1.9	-2.1	-0.4	2.1	-0.6	-0.9
Panama	-7.8	-6.0	-7.6	-5.0	-0.4	-3.2	-4.1
Peru	-2.2	-0.9	-1.3	-0.7	1.2	-2.3	-4.5
Uruguay	0.8	0	-0.5	1.5	-0.9	-2.7	-2.5

Sources: IMF World Economic Outlook April 2023.

The rise in world interest rates and the return of inflation

In addition to the slowdown in the world economy and the fallout from the prolonged lockdowns in China, the short- to medium-term macroeconomic outlook for Latin America has been complicated by two factors: the rise in world interest rates and the return of inflation, both at home and abroad (see table 5). The initial impetus for price increases came from collapsed supply chains and food scarcity caused by Russia's invasion of Ukraine. It amounted to a cost-push shock[3] to the world economy, and for the region. A second cost-push shock came from the strength of the U.S. dollar. The larger economies in Latin America, with the exception of Argentina, have floating exchange rates. As the dollar gained and their own currencies depreciated, the domestic value of imports rose, helping fuel inflation.

There was a third reason for higher inflation in Latin America. Fiscal and especially monetary policy operate with long and variable lags, so consumption demand was still high when the adverse supply shocks hit. In addition, putting one's foot on the budget accelerator is easy but taking it off is hard. In a few countries, the fiscal boost lasted longer than it should have.

The good news is that central bankers in Latin America moved against inflation early, as figure 2 reveals. Brazil was the first to launch a tightening cycle, in May 2021. Chile, Mexico, Colombia, and Peru followed shortly thereafter. By contrast, the U.S. Federal Reserve waited until March 2022, and the European Central Bank until late July 2022. This early reaction indicates that most central banks in the region remain independent and focused on price stability, despite political turmoil.

Inflation has proved to be stubborn, which is not entirely surprising given the size of adverse supply shocks. Containing inflation when costs are rising is difficult, because firms only refrain from passing higher costs on to consumers if their sales are weak and prospects dim. This means that a given reduction in inflation requires higher interest rates and weaker activity.

But it would be wrong to conclude that it has been all pain and no gain for the countries in Latin America. After a period following the early tightening, when core inflation kept rising, the policy stance now appears to be achieving the desired results. For example, inflation in Brazil has come down sharply. In Chile, Mexico, and Peru, late 2022 and early 2023 readings also suggest inflation is falling, albeit slowly. The drop in inflation

3 "Cost-push inflation theorizes that as costs to producers increase from things like rising wages, these higher costs are passed on to consumers" (https://www.investopedia.com/terms/c/costpushinflation.asp#:~:text=Cost%2Dpush%20inflation%20theorizes%20that,for%20sustained%20periods%20of%20time.).

Table 5. CPI inflation rates, major Latin American countries, 2017–22
End of period (%)

COUNTRY	2017	2018	2019	2020	2021	2022
Argentina	24.80	47.65	53.83	36.14	50.94	94.79
Brazil	2.95	3.75	4.31	4.52	10.06	5.8*
Chile	2.27	2.57	3.00	2.97	7.17	12.79
Colombia	4.09	3.18	3.80	1.61	5.62	13.12
Costa Rica	2.57	2.03	1.52	0.89	3.30	7.9*
Dominican Republic	4.20	1.17	3.66	5.55	8.50	7.83
Ecuador	-0.20	0.27	-0.07	-0.93	1.94	3.74
Jamaica	5.19	2.52	6.15	5.22	7.33	9.5*
Mexico	6.77	4.83	2.83	3.15	7.36	7.82
Panama	0.48	0.16	-0.06	-1.57	2.62	2.1*
Peru	1.50	2.49	1.87	2.15	6.99	8.56
El Salvador	2.04	0.43	0.00	-0.09	6.11	7.3*
Uruguay	6.55	7.96	8.79	9.41	7.96	8.3

Source: International Monetary Fund. *Projections from *World Economic Outlook April 2023*.

is the result of both local monetary tightening and the normalization of global supply chains, which have contributed to worldwide disinflation.

There are several caveats to this optimistic conclusion. One is that inflation reduction will not come without a cost. Part of the very slow output performance forecast for 2023—including near-zero growth for once-fast-growing Chile—is due to the tighter monetary stance.

A second caveat has to do with the drying up of fiscal space and the sustainability of public and private debt levels. For most countries except Mexico, one legacy of the COVID-19 pandemic was elevated debt stocks, which in the case of Brazilian and Argentine public debt exceed 80 percent of GDP. The good news is that in most countries, a much larger share of the outstanding debt is in domestic currency. The bad news is that maturities shortened during the crisis, leaving governments more exposed to the fast rise in local and global interest rates. Higher debt-service burdens will place growing pressure on Latin America's public finances in the years to come.

A third caveat has to do with the stability of international capital flows. History shows that previous spikes in U.S. interest rates provoked sudden stops in capital flows to one or more countries in Latin America. The debt crisis provoked by the "Volcker moment" of the early 1980s was the most obvious and most generalized of these episodes, but not the only one. Countries in the region must remain vigilant and build liquidity buffers (whether via accumulation of international reserves or access to dollar credit lines) to ensure history will not repeat itself, with painful consequences.

At the same time, the risks should not be overstated. The fact is that, unlike in previous episodes of international financial stress, no Latin American country has lost market access (although some did not have it to begin with, of course), nor has a domestic banking or financial crisis erupted anywhere. This is testimony to the improvements in domestic financial supervision and macroprudential policy in many countries of the region.

Failing to converge: Longer-term challenges

The Latin American region faces many longer-term challenges, among which sluggish economic growth is one of the most important (see table 6). Without faster, more sustained growth, solving social and distributional problems becomes increasingly challenging.

The region enjoyed a spurt of growth during the commodity supercycle in the early 2000s (figure 4). However, with only one or two exceptions, there has been little growth since the end of the boom eight to 10 years ago. A key policy question is what needs to be done to ensure growth in conditions of less favorable commodity prices, a scenario that seems likely to prevail given that China's economy is no longer expanding at very high rates and driving worldwide demand for commodities.

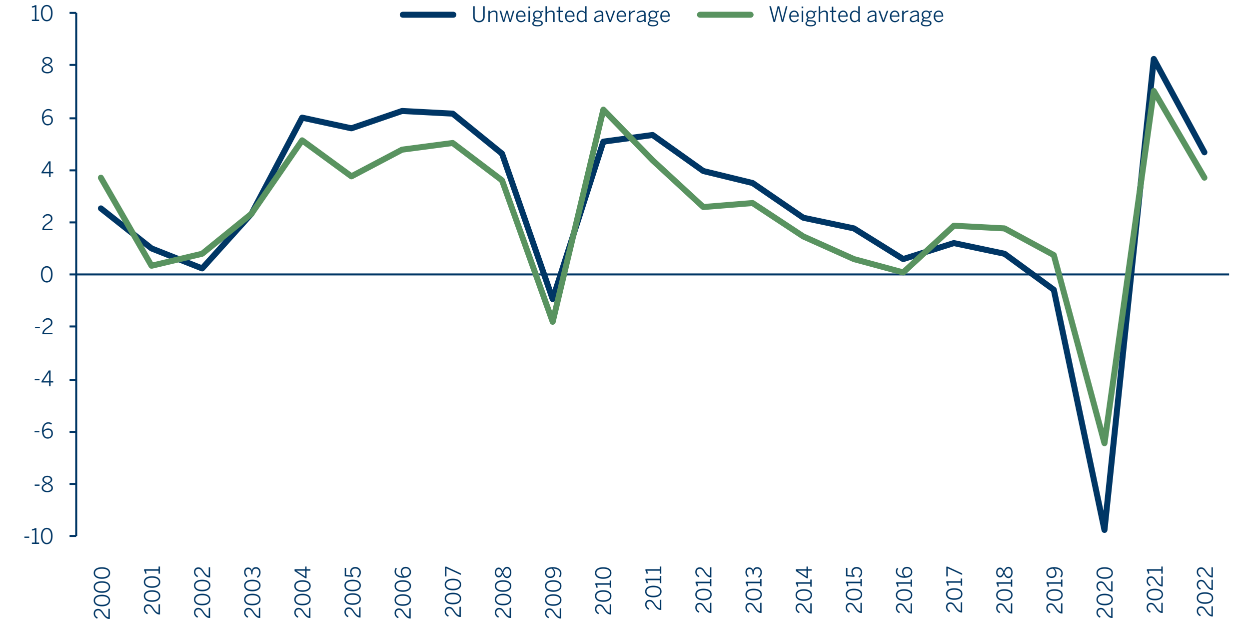
Not only has headline growth declined in the last decade, but so has trend growth. Figure 5 shows long-term trend growth rates, as estimated by the Inter-American Development Bank for 1995–99 and 2015–19. These estimates correct for short-term fluctuations and attempt to isolate an economy's capacity to grow, based on long-term investment and productivity performance. As figure 5 shows, compared to two decades ago, every major economy in Latin America displays a lower growth trend. Figure 6 shows more recent growth trends compared with 2000–05, and the story is the same: this growth trajectory is slower. This ought to be a wake-up call to policy leaders throughout the region. Growth needs to become a national priority, which it often is in Asia but not Latin America, at least not in the current political climate. Regional cooperation has been sporadic and mostly ineffective in Latin America. In contrast, many Asian economies have cooperated effectively for decades to enhance growth prospects for the region.

Table 6. Annual GDP growth, major Latin American countries, average 2000–22

COUNTRY	AVERAGE RATE (%)
Panama	5.3
Dominican Republic	4.8
Peru	4.4
Costa Rica	3.8
Colombia	3.8
Chile	3.6
Ecuador	2.9
Uruguay	2.4
Brazil	2.3
El Salvador	1.9
Argentina	1.9
Mexico	1.8
Jamaica	0.5
Venezuela	-2.8

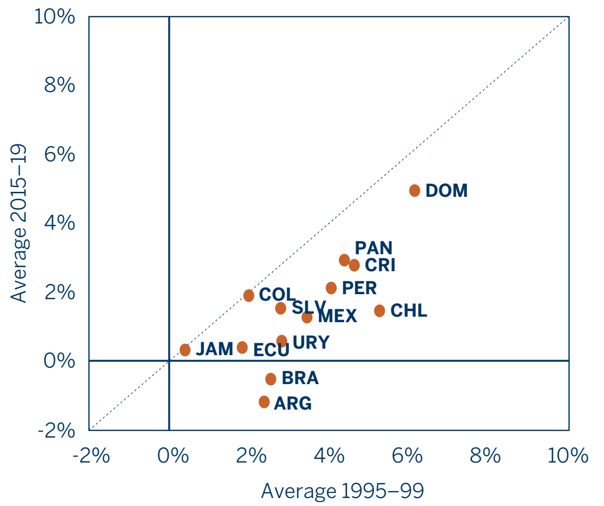
Source: IMF *World Economic Outlook April 2023.*

Figure 4. Annual GDP growth, major Latin American countries, 2000–22
Percent



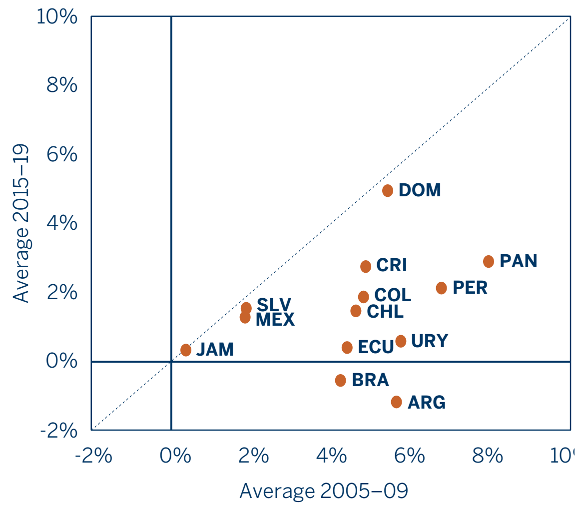
Source: IMF *World Economic Outlook April 2023.*
Note: Weights are calculated using GDP in purchasing power parity international dollars.

Figure 5. Long-term trend growth rates, average 1995–99 and 2015–19



Source: Inter-American Development Bank.

Figure 6. Long-term trend growth rates, average 2005–09 and 2015–19



Source: Inter-American Development Bank.

During 1990–2019, per capita GDP growth averaged just 1.73 percent (1.82 percent if the Caribbean is excluded), less than half the 3.90 percent average rate in Emerging Asia, and barely above the 1.68 percent posted by the much richer advanced countries (table 7). So, in these three decades, Latin America failed to close the gap with advanced nations, despite what standard convergence theory would predict.

Why do Latin American economies have such low growth? A natural place to start looking for an explanation is a standard Solow growth accounting exercise (table 7). The contribution of capital accumulation was exactly zero, so that investment in physical capital has been low enough to make no contribution to per capita economic growth. At the same time, the contribution of total factor productivity was (slightly) negative. We further document and explore these two findings below, but details should not distract attention from this dismal performance. Especially worrying is that productivity was stagnant over these three decades. That is, the same worker and the same machine produced no more output in 2019 than it did in 1990. In stark contrast, in Emerging Asia, total factor productivity accounted for an average of 1.5 percent per capita annual growth over the period.

Total factor productivity estimates can be volatile and not particularly robust, since they depend on estimates for difficult-to-compute stocks like physical and human capital, and can also be affected by the business cycle, as rates of utilization of capital stock vary across the cycle. Nonetheless, the results in table 7, computed over a long time period, do suggest that the productivity problem is large and sustained. This ought to be a main focus for policymakers.

During 1990–2019, the largest source of growth was per capita labor input, which contributed nearly a whole percentage point per year. This was because a growing share of the working-age population was engaged in work, a development closely related to the increase in the participation of women in the labor force. This is good news, and even better news is the fact that additional growth can come from this same source in the future, since female labor force participation in Latin America is still substantially below that of advanced nations (Frisancho and Queijo 2022).

The performance of investment in human capital is also revealing. Accumulation of skills accounted for an average annual contribution to growth of 0.82 percent over the period. The figure is substantial, even if far below the 1.29 percent equivalent number for Emerging Asia. This suggests that increases in years of schooling—a development in almost all Latin American countries (figure 7)—has had a positive impact on growth, despite lingering and fully justified concerns over the quality of teaching and mismatches between the skills schools teach and the skills the labor market requires. At the same time, the region has a long way to go to match the extraordinarily growth-enhancing education performance of Asian countries.

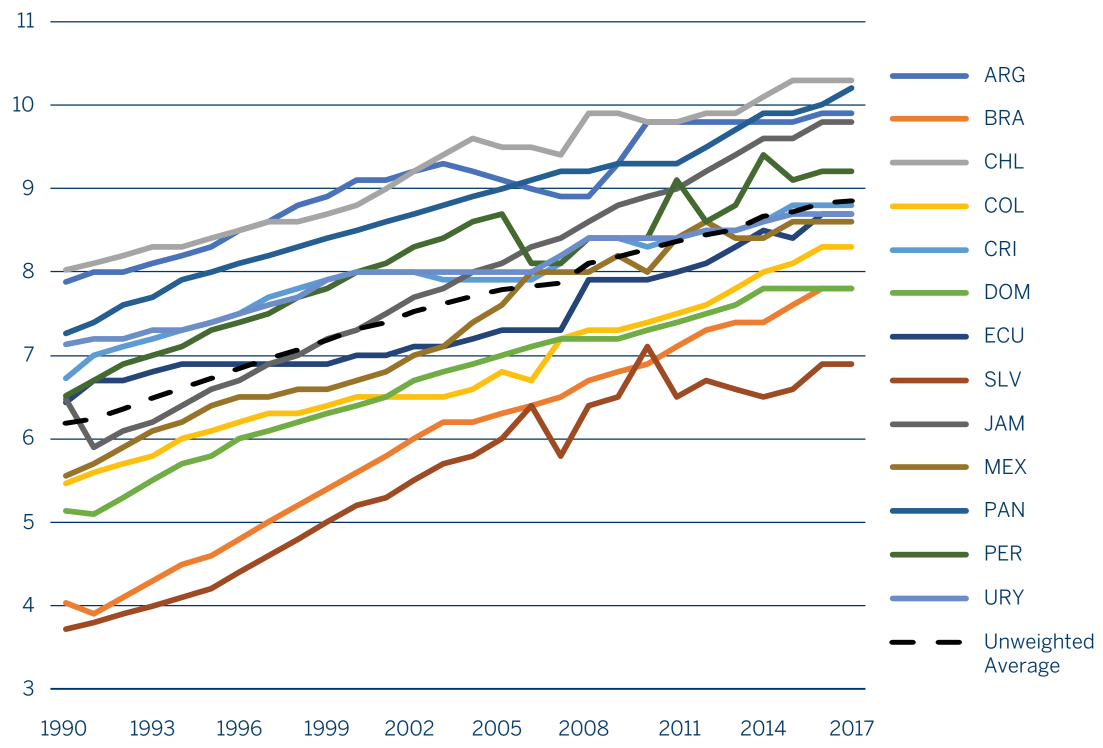
Table 7. Contribution to GDP growth, 1990–2019

Growth rates in percent, contributions in percentage points

	GDP GROWTH (PER CAPITA)	CONTRIBUTION OF:			
		TOTAL FACTOR PRODUCTIVITY	CAPITAL ACCUMULATION	SKILLS	LABOR
	$\Delta\left(\frac{Y}{N}\right)$	$\frac{1}{1-\alpha}\Delta A$	$\frac{\alpha}{1-\alpha}\Delta\left(\frac{K}{Y}\right)$	Δh	$\Delta\left(\frac{L}{N}\right)$
Advanced Economies	1.68%	0.88	-0.18	0.61	0.36
United States	1.52%	1.66	-0.29	0.19	-0.05
Emerging Asia	3.90%	1.50	0.57	1.29	0.55
Latin America and the Caribbean	**1.73%**	**-0.03**	**0.00**	**0.82**	**0.94**
Latin America	1.82%	0.03	-0.04	0.84	0.98
Caribbean	1.15%	-0.46	0.21	0.70	0.70

Source: Inter-American Development Bank.

Figure 7. Average years of schooling, major Latin American countries and Latin America unweighted average, 1990–2017



Sources: Lee-Lee 2016; Barro-Lee 2018; UNDP 2018.

Latin America and its peers

To place Latin America's performance in a broader perspective, we construct a group of extra-regional peers of similar level of income per capita and development, which includes Bulgaria, the Czech Republic, Egypt, Hungary, Indonesia, Malaysia, the Philippines, Poland, Romania, South Africa, Thailand, and Turkey.[4] In 2019, the (weighted-by-GDP) average of the GDP per capita of this group was US$8,881 (in 2015 dollars). The same figure for Latin America (Argentina, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Jamaica, Mexico, Panama, Peru, and Uruguay) was US$9,590. So, the region has slightly higher income (in per capita terms) than its group of peers.

In 1970, the (weighted-by-GDP) average of GDP per capita of Latin America was US$5,216 (in constant 2015 dollars) compared to US$2,700 for the peer group. Since 1970, the peer group has had significantly more growth—Latin America's per capita income has grown by 1 percent compared to 2 percent for its peers.

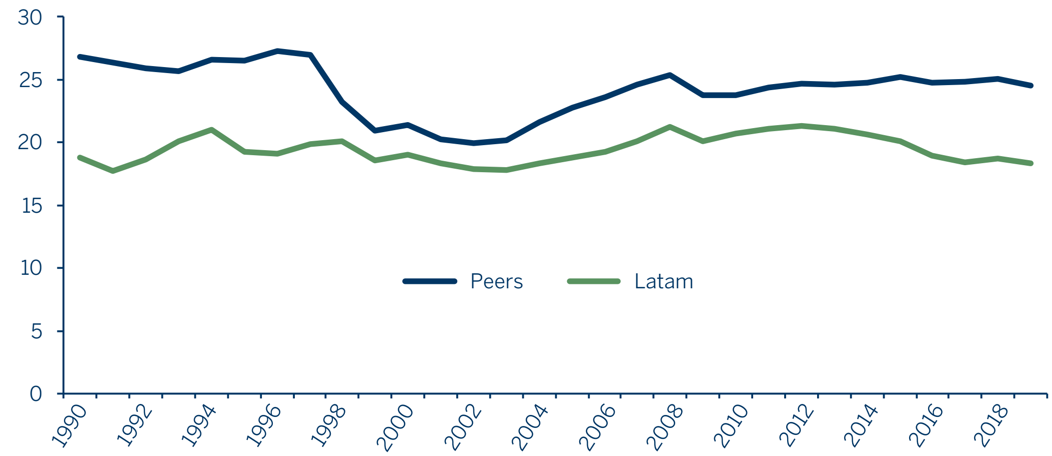
Figure 8 shows the comparative investment performance of Latin America and its peers. The group of peers does substantially better, with investment rates (as a share of GDP) that oscillate around 25 percent. By contrast, in Latin America, investment rates oscillate around 20 percent of GDP, with a slight but sustained downward trend in the last decade. Several factors likely account for this performance. A long lived-constraint is low domestic savings, which means that increases in investment cause

4 Of course, the peer group is heterogeneous, with some nations such as the Czech Republic and Poland much richer and further developed than others in the group, such as Egypt. But Latin America is also heterogeneous, with a sizable income gap between the countries at the top of the income scale (Panama, Uruguay, Chile) and those at the bottom (such as Haiti, Bolivia, Honduras, and Suriname).

current account deficits that are typically financed by foreign savings, which in turn can dry up exogenously when international conditions shift. Factors that have dragged investment down in recent years include the drop in commodity prices since the end of the super-cycle, given that so much of Latin American investment goes to commodity-dependent sectors; growing political uncertainty in several countries; and the deterioration in the investment environment.

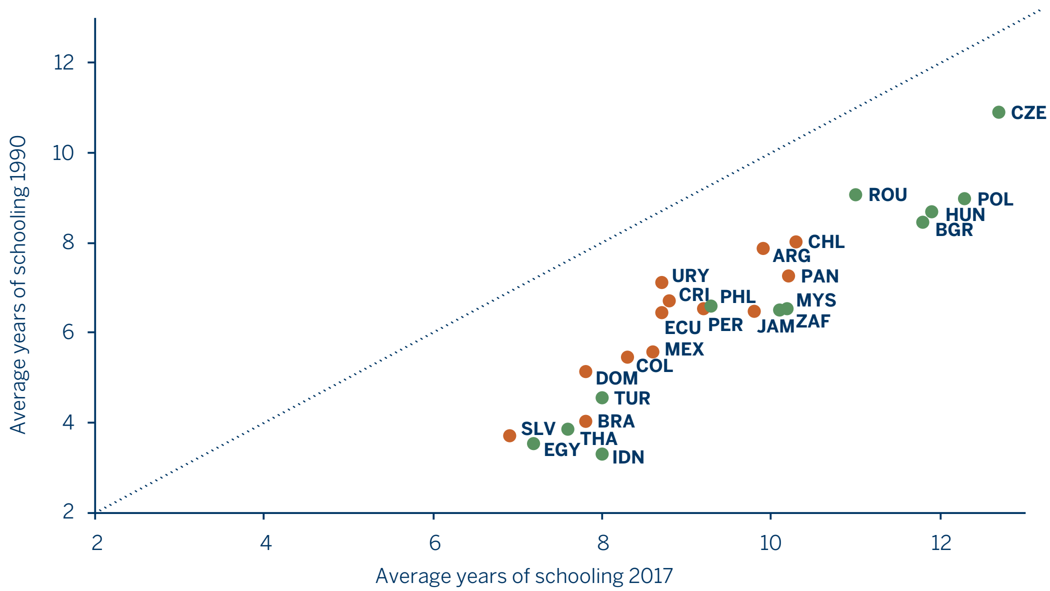
Figure 9 presents two snapshots of human capital accumulation for Latin America and the peer group: years of schooling in 1990 and 2017. The Central and Eastern European nations among the peers (Bulgaria, the Czech Republic, Hungary, Poland, and Romania) deliver

Figure 8. Gross fixed capital formation, GDP-weighted average, 1990–2019
Percent of GDP



Source: World Bank.

Figure 9. Investment in human capital, Latam and peers, 1990 and 2017



Source: Lee-Lee 2016; Barro-Lee 2018; and UNDP 2018.
Note: Latam = Latin America.

between one and three years more of education than does Chile, the Latin American country that in 2017 performed best in this respect. But every nation in Latin America is substantially to the right of the 45-degree line, meaning that countries in the region increased the years of schooling they offer the population. Colombia, for instance, went from 5.5 years to over 8 years, Argentina from a little over 8 to nearly 10 years, and Panama from a little over 7 years to more than 10. These figures refer to years of education; quality is another matter altogether.

Figure 10 shows the average total factor productivity (TFP) of the Latin American group and the peer group, measured as shares of the TFP level in the United States, which can be thought of as "the frontier." Three observations stand out. First, both Latin America and its peers have remained substantially within the frontier in the last quarter century. Second, TFP levels among the peers are consistently above those of Latin America during the period. Third, Latin America's relative productivity has been on a gradual but sustained decline since the mid-1990s. That is, the region has been falling further behind the frontier. There are many technical reasons for this decline, but the region's dismal performance should ring alarm bells and warrants attention.

Explanations for low productivity

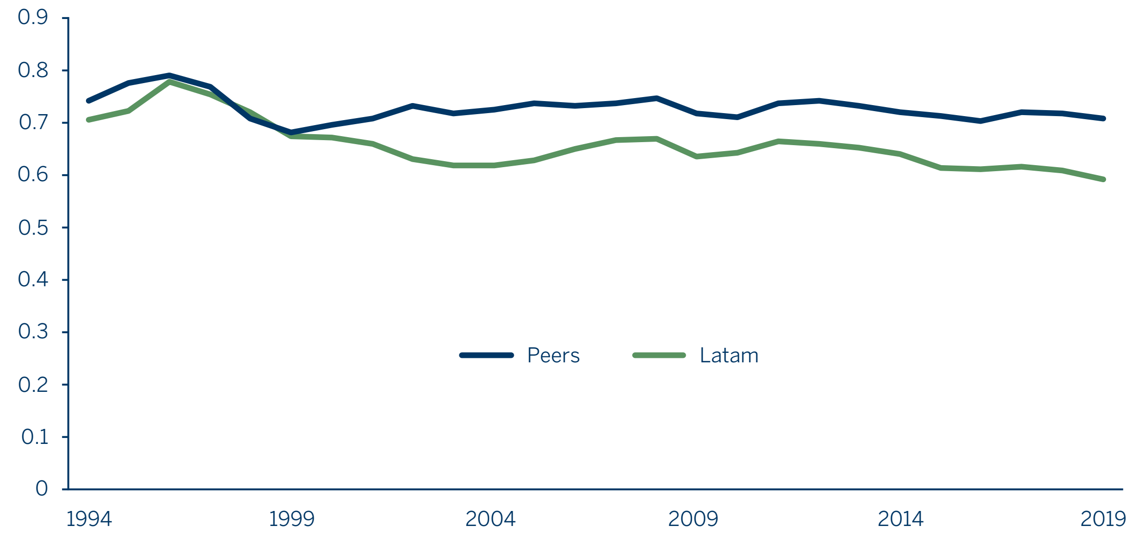
The two most frequently cited explanations for Latin America's disappointing productivity performance are misallocation within and among firms within a sector, and misallocation across sectors. In both cases, the problem derives from devoting resources to the "wrong" use, but the two explanations convey two different sets of problems with very different policy implications.

The first explanation emphasizes the tremendous differences in productivity across firms. Small firms tend to be less productive than large ones, formal ones more productive than informal ones, and productivity in manufacturing tends to be higher (and rise more quickly) than productivity in services. These gaps persist because distortions prevent resources from being reallocated from low-productivity firms to high-productivity firms. Even worse, mis-designed regulations can cause resources to flow away from high-productivity firms and toward low-productivity firms, such as when low-productivity firms face a lighter regulatory load or fewer restrictions on hiring and firing.

Levy (2008, 2018) has compiled a great deal of evidence that supports this hypothesis in the case of Mexico.

Figure 10. Average TFP weighted by GDP, 1994–2019

USA=1



Source: Penn World Table 2019.
Note: Latam = Latin America.

He argues (2018) that policies related to "taxation, labor and social insurance regulations, and enforcement of contracts" have caused systematic resource misallocation and have held back growth. Arnold and Grundke (2021) make a similar case for Brazil, focusing on the role of high minimum wages and product market regulation. Mexico and Brazil are not the only countries in this situation. In a paper for the Inter-American Development Bank, Busso, Madrigal, and Pagés-Serra (2012) quantified how costly misallocation is for aggregate productivity in Latin America. To do so, they computed how much output an economy loses by allocating resources inefficiently.

They conclude that the potential TFP gains from eliminating distortions in product and input markets are very large. The simulations suggest Mexico could more than double its total factor productivity and output by eliminating distortions and reallocating resources so as to equalize marginal returns across firms. Potential gains are 50 percent or above in Argentina, Bolivia, Ecuador, El Salvador, Uruguay, and Venezuela.

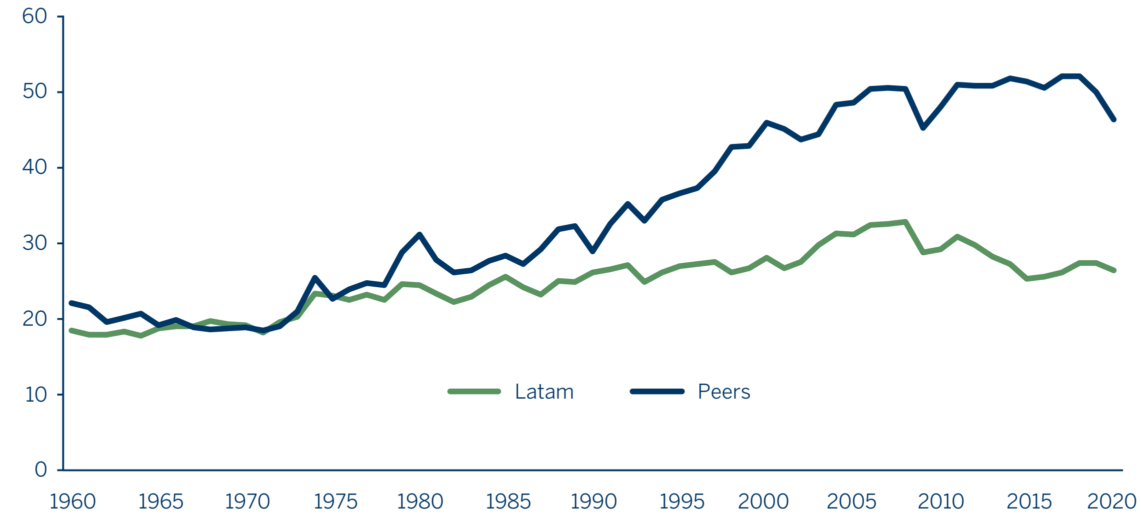
The approach that emphasizes across-firms misallocation has clear policy implications. As Levy (2018) puts it, the problem is that "policies and institutions deployed to enhance social inclusion tax the high-productivity sector of the economy and subsidize the low-productivity sector, stifling productivity and dampening growth." Therefore, when discussing how to reignite growth, we must shift from "policies that affect human and physical capital accumulation to a discussion of the institutions and policies that impede the efficient use of the country's human and physical capital (and which in turn reduce the incentives to accumulate physical and human capital)."

The list of policies that potentially affect the efficient use of resources includes labor market restrictions on hiring and firing, which are typically high in Latin America (Heckman and Pagés 2004; David, Pienknagura, and Roldós 2020), and social regulations that create incentives to stay out of the formal labor market. Also included are policies designed to help small and medium-sized enterprises—for instance, special tax regimes—that have the effect of keeping those enterprises small because they lose benefits if they grow too much. So do legal and enforcement failures that prompt an excessive reliance on family-run firms, where growth is limited by succession and span-of-control issues (Villalonga and Amit 2006; Bennedsen et al. 2007).

We now turn to the potential misallocation across sectors, particularly between exportable goods and the rest. It is commonly said that, in the context of an endogenous growth model, activities that generate long-run growth (via externalities in research and development, expanding product variety, upgrading product quality,

Figure 11. Exports of goods and services, GDP-weighted average, 1960–2020

% of GDP



Source: World Bank.

and so on) are more common among exportables than in the sectors focused on the domestic market. A more open economy is assumed to be able to allocate resources to those "high-potential" sectors and increase growth.[5]

Figure 11 shows the degree of openness of Latin American economies and their group of peers, measured as the sum of imports and exports over GDP. The ratio is similar between 1960 and 1990, but then a gap develops, with the peer economies progressively becoming substantially more open, while the ratio for Latin America also increases, but at a much slower pace. The result is that by 2018, before the COVID-19 crisis caused a worldwide contraction in trade, the peer economies were roughly twice as open as the Latin American economies, with ratios in the mid-20 percents for the region and over 50 percent for the peer group. If there is a connection between trade and growth, Latin America has not been benefiting from it as much as it could.

A related argument that connects exports and possible misallocation focuses on diversification. The reason why growth slows as economies become richer is that at the margin the returns on new investments in existing sectors fall, and so does the incentive to keep investing in and expanding those sectors. This is the standard convergence story. But if there exist other export sectors where returns are higher, then it makes sense to reallocate resources toward them, in a process that keeps enlarging the range of products a country exports, prevents returns from falling, and hence extends the period during which an economy can experience fast growth.[6] So, other things being equal, a country with a more diversified export sector should be able to grow faster or keep growing at the same speed for longer.

Why might complexity be "inefficiently low" in a given economy? One explanation is that trade, tax, and regulatory policies create barriers to the movement of resources toward new sectors. That would be a case of policy failure, and the first best policy would be directly to remove those distortions. Another explanation is that coordination failures and externalities stunt the market signals that would lead entrepreneurs to reallocate resources in the direction of greater complexity. That would be a case of market failure, which can be remedied via the standard policy remedies of targeted subsidies and private-public efforts to improve coordination.

Figure 12 shows the average diversity of exports for the Latin American region and the peer group for 1990–2020. The peer group shows a more diversified export structure throughout, and the degree of diversification rises more quickly among the peers than it does for Latin America countries. On average, during 1995–2018, peers had 1.7 times more goods in their export baskets than the Latin American group. This could be one reason why countries in the peer group tend to grow faster over the long run than do countries in the region.

There also exists a relationship between the kinds of goods a country exports and the skills a country needs to produce those goods. An economy with a more diversified productive structure must have acquired the skills needed to produce this complex set of goods, and since these skills may also prove useful for the production of additional goods not yet produced, there is a sense in which more diversified economies find it easier to keep diversifying and, therefore, growing. This is consistent with the stylized fact that richer countries tend to have more diversified export baskets, contrary to what a misreading of standard Ricardian comparative advantage might suggest.

Hausmann, Hwang, and Rodrik (2007) have built an index that ranks traded goods in terms of their implied productivity and showed that this is a robust predictor of subsequent economic growth. In subsequent work, the Growth Lab at Harvard University has developed a measure of the "economic complexity" of a country's export basket,[7] which is a weighted average of how diversified it is and how "ubiquitous" those exports are—that is, how many other countries export the same goods. Again, there are good reasons—and evidence—that countries whose economic complexity is greater than would be expected, given their current level of income, tend to grow faster.

Why might complexity be "inefficiently low" in a given economy? There are many possible explanations, but the key lies in the availability of skills and know-how—not just general skills such as those produced by more average years

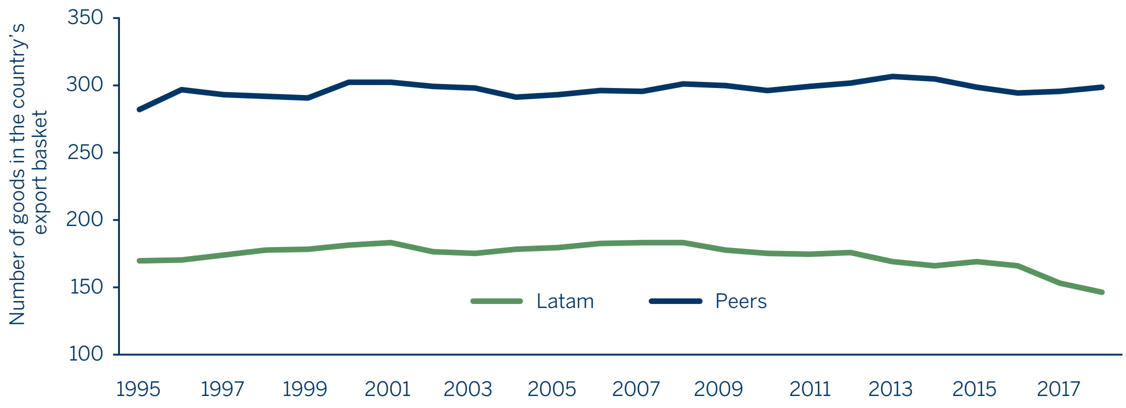
5 The full story is slightly more complicated, since opening up to trade can also reallocate resources away from the growth-enhancing sector (see Grossman and Helpman 1991), or, in fact, the growth argument could justify a tariff that enlarged the growth-enhancing sector and thereby spurred growth (see Rodríguez and Rodrik 2000).

6 For a classic discussion of these issues, with an application to the East Asian experience, see Young (1992).

7 Atlas of Economic Complexity 2014; https://atlas.cid.harvard.edu/.

Figure 12. Diversity of exports, major Latin American countries and peers, 1995–2018

Number of goods in the country's export basket, simple average by group



Source: *Atlas of Economic Complexity.*

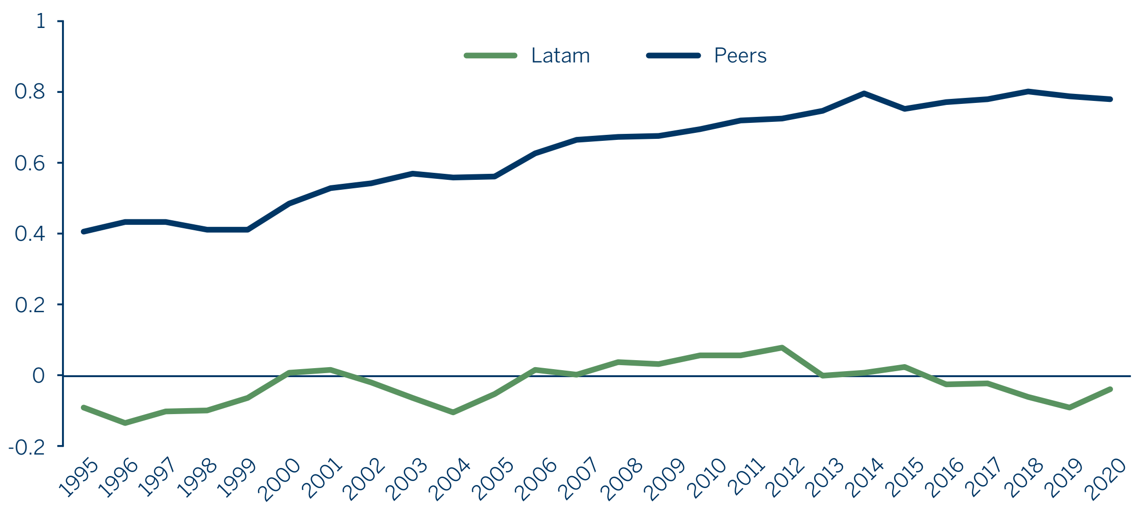
of school education, but sector-specific skills that tend to be acquired in highly specialized technical training or on the job and through mentoring. In addition to further opening the economy to trade in goods, the policies that make a difference in this domain include technical training, the foreign investment regime (multinational firms contribute to the diffusion of skills and know-how), and migration rules (immigrants from certain countries with a tradition of producing a given good are likely to bring the skills needed for domestic production of that good).

Figure 13 shows the (arithmetic) average of the complexity index of exports for Latin America and its peers. The figure reveals substantial differences across regions. Not only are the exports of the peer group substantially more complex than those of the region, but this gap has grown over time. If complexity is a future source of economic growth, Latin America is failing to take advantage of those growth opportunities.

Figure 14 shows the evolution of the Economic Complexity Index for individual countries in the region. We can see that since 2000, complexity has been

Figure 13. Economic Complexity Index, 1995–2020

Simple average by group



Source: *Atlas of Economic Complexity.*

falling consistently in Argentina, Brazil, and Peru. In others, including Chile, Colombia, and Uruguay, it has displayed some slight ups and downs, but the overall picture is one of stagnation or slight decline. In addition to Mexico, the only clear winners are small nations in Central America and the Caribbean: Costa Rica, the Dominican Republic, and Panama.

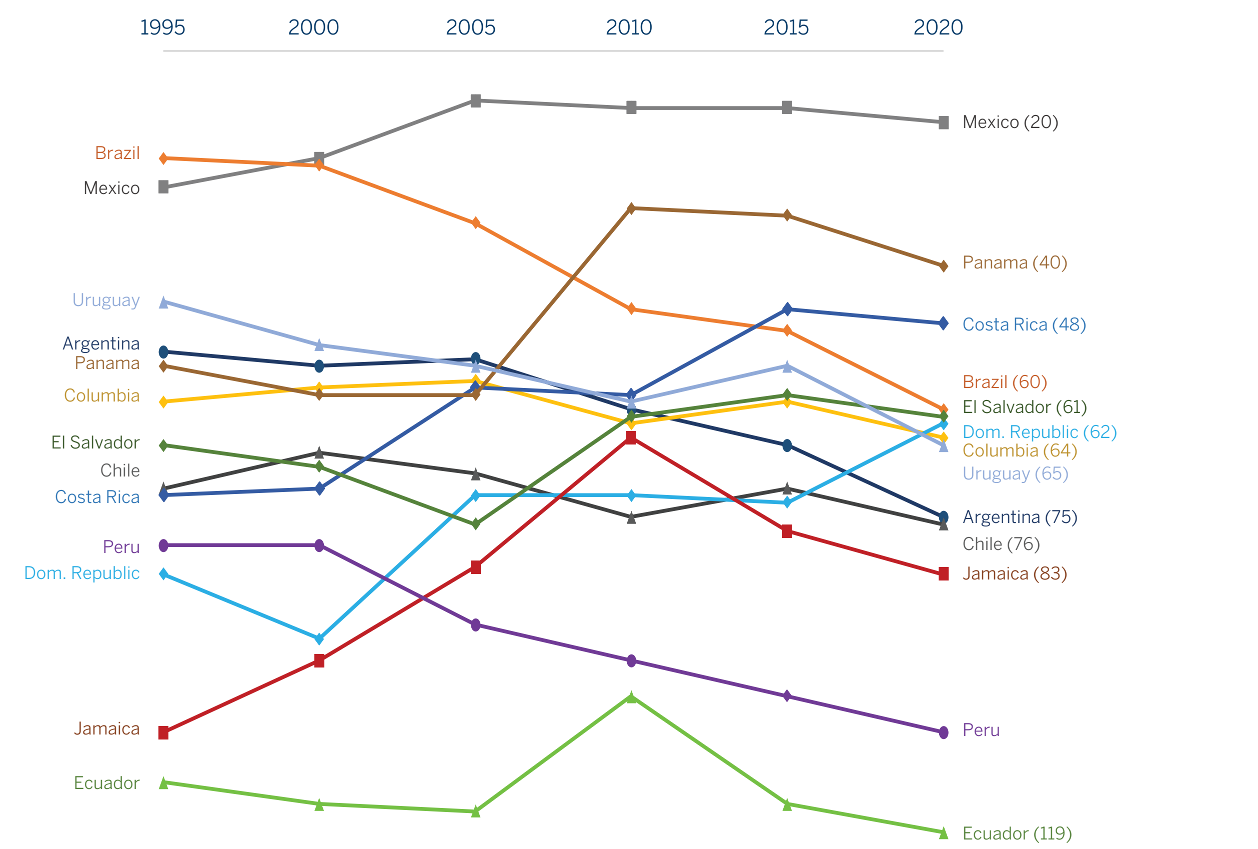
Intracountry productivity variations

Averages can be misleading. In the large countries, particularly in Brazil and Mexico, there are big regional productivity differences. In Mexico, Monterrey has productivity levels comparable to those of a Southern European country, while Oaxaca or Chiapas in the south have the productivity of a Central American nation. Similarly in Brazil, the productivity gap between São Paulo State on the one hand, and the low-income states of the Northeast on the other hand, remains substantial.

Figure 15 displays the value added per worker in Mexican states in 2018 (instead of total factor productivity), but the large gaps are similar to those of Brazil. At the top are Mexico City and industrial states like Nuevo León (of which Monterrey is the capital) and Campeche, which concentrates oil-related assets. At the bottom are poor states in Mexico's south, like Guerrero, Oaxaca, and Chiapas.

Even worse, Iacovone et al. (2022) find evidence of "limited or weak absolute productivity convergence across states since 1993," but strong convergence across municipalities within a given state. Schettini and Azzoni (2018) also find limited evidence of convergence among states in Brazil, with the exception being states in the South where export-oriented agribusiness is important. Productivity gains have been sizable in that sector, and larger than in other productive sectors.

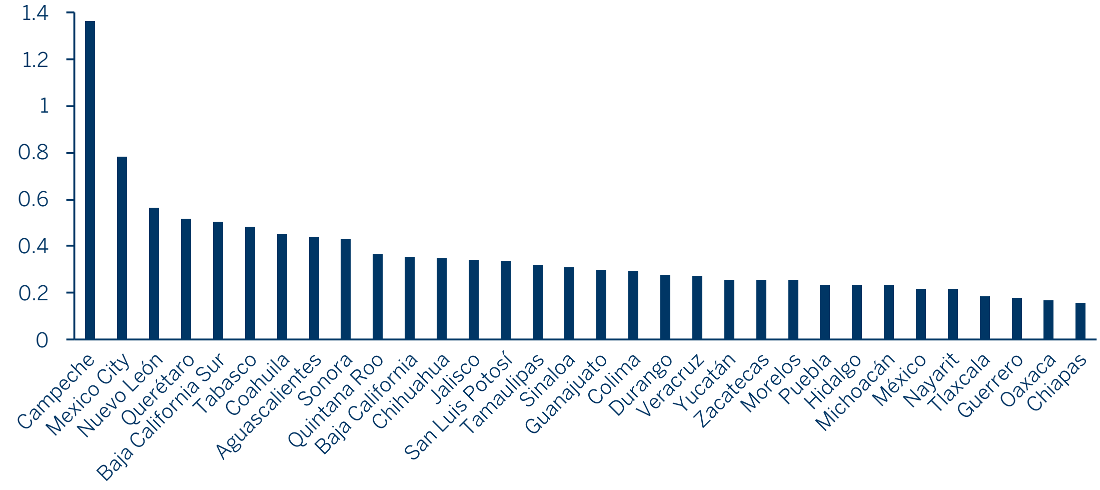
Figure 14. Ranking of Economic Complexity Index, Latin American countries, 1995–2020



Source: *Atlas of Economic Complexity*.

Figure 15. Value added per worker, Mexican states, 2018

Millions of 2013 constant local currency



Source: Iacovone et al. 2022.

Why is there so little within-country convergence, even when gaps in per capita income across states are so large? In a world in which all factors of production are mobile, convergence should be fast, but that is not what we observe. High-quality agricultural land is one obviously immobile factor. And skills, embodied in workers, may be less mobile than is often assumed. There are also large differences in the quality of the business environment across regions. Some have better infrastructure, better law enforcement, and less crime and corruption than others. Such gaps are obvious between the south of Mexico and the rest of the country, and between the Brazilian Northeast and other regions. But, of course, factors like the provision of infrastructure are endogenous: regions with thriving economic activity raise more revenue and hence have more resources with which to finance infrastructure investment.

This suggests low productivity traps can also account for large regional differences. In the case of Chiapas in Southern Mexico, Hausmann, Espinoza, and Santos (2015) argue: "Modern production systems require a number of complementary inputs that are absent in Chiapas. In this context, productive diversity and private investment are low because returns to investment are also low. Given that demand derived from investment is low, supply of complementary inputs is inhibited." A simple example comes from the tourist industry. To thrive, it might need personnel who can speak English. But there are no incentives for local waiters to learn English (or for English-speaking waiters to move to Chiapas) if there is little demand for highly trained workers. Another, better, equilibrium exists, but the local economy cannot reach it.

Growth diagnostics: Four Latin American syndromes

It is tempting to lump all Latin American growth failures into one general-purpose narrative: macroeconomic and political instability, low institutional quality, insufficient investment in physical and human capital, poor contract and law enforcement, and corruption. Given these factors, it cannot be surprising that the region does not grow. But this approach is too simple, for several reasons.

First, growth has not always been low in the region. Mexico in the 1950s, 1960s, and 1970s; Brazil in the 1960s and 1970s; Chile in the 1990s; and the Dominican Republic and Panama more recently, have all experienced periods of fast growth.

Second, the growth-impeding ills are not as generalized as conventional wisdom might suggest. Yes, low institutional quality and weak rule of law are serious issues, but on these dimensions, countries like Chile, Costa Rica, and Uruguay have scores not far from (and sometimes better than) those in developed countries in Southern Europe. Macroeconomic instability is not to be minimized, but Chile, Colombia, Mexico, and Peru enjoyed a quarter century of low inflation and reasonably strong public finances until the recent worldwide inflation crisis hit.

Third, countries that have managed to remove most, if not all, of these growth-impeding factors, have not grown on a sustained basis, anyway. Chile, the Latin American model of good policies and institutions plus stable macroeconomy, is an example: it grew quickly in the 1990s and the early 2000s, but has grown little over the last 15 years. Mexico is another example of a country where many reforms have taken place (paramount among them is trade integration with the United States and Canada), and yet growth continues to disappoint.

To paraphrase Tolstoy, all countries are alike, but each unhappy country is unhappy in its own way.[8] In what follows we distinguish four syndromes of low growth in Latin America, describe their features, and briefly speculate about causal factors.

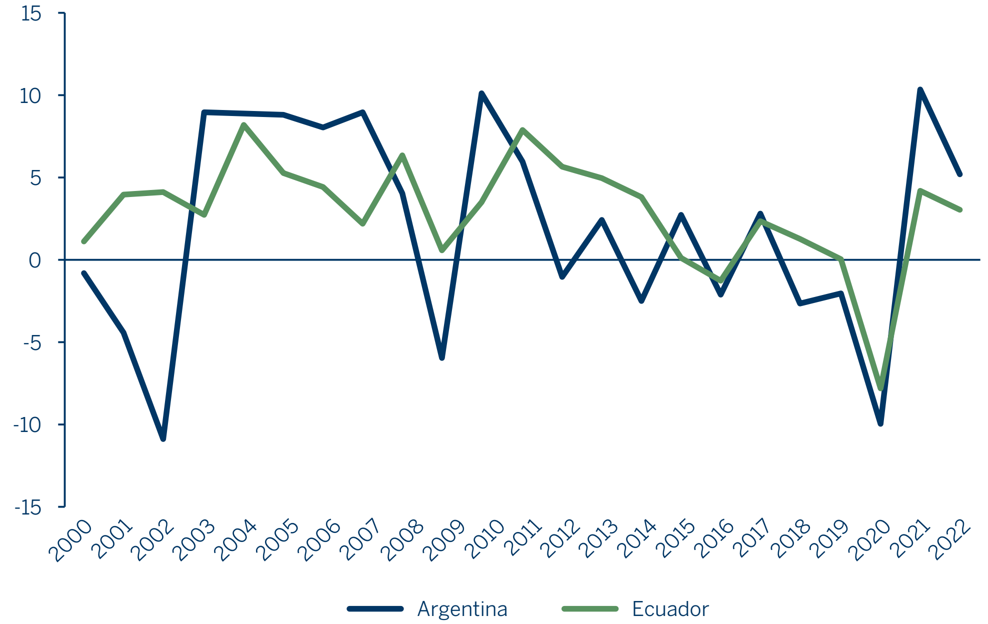
Endemic macroeconomic instability: Venezuela, Argentina, and Ecuador

Venezuela is, of course, in a league of its own, with GDP contracting by roughly two-thirds between 2014 and 2020, and a recent bout of hyperinflation.[9] Sadly, the Venezuelan crisis has gone far beyond a political and economic collapse and become a humanitarian crisis of a magnitude unprecedented in the region. But Venezuela is not the only country with sustained and serious macroeconomic problems. Argentina and Ecuador, although

8 Russian novelist Leo Tolstoy opened his novel, *Anna Karenina*, with the famous line: "All happy families are alike; each unhappy family is unhappy in its own way."

9 Congressional Research Service 2022.

Figure 16. Annual GDP growth rates, Argentina and Ecuador, 2002–22
Percent



Source: IMF *World Economic Outlook April 2023.*

different from Venezuela and in some dimensions from each other, have some common elements, as well.

Argentina's macroeconomic experience has been studied at length, and revisiting it in any depth is beyond the scope of this paper. Suffice it to say that inflation reached almost 95 percent in 2022, and that after recovering strongly over the past two years, the economy is expected to stagnate (with growth around zero) in 2023. With no access to the international market, the fiscal deficit is being financed through a mixture of domestic bond issuance and money creation, repeating the narrative of previous crisis episodes. But with overall public debt at 80 percent of GDP, and local debt of increasingly short maturity, ongoing rollovers are not guaranteed during the electoral year of 2023. That, in turn, could mean larger monetary financing, further fueling an inflation rate that should exceed 100 percent this year.

Ecuador is an interesting case, because, having dollarized in 2000, it does not experience the high inflation of Argentina and other countries of the region. But macroeconomic stability is about more than low inflation. Ecuador's public debt went from 16 percent of GDP in 2009 to 45 percent in 2017 and is estimated at 60 percent today. As a result, it defaulted on debt payments in 2020, during the pandemic, and regularly endures some of the largest risk spreads in the region.

As figure 16 shows, what Argentina and Ecuador have in common, in addition to low trend growth, is substantial growth volatility, with some sharp recessions in the last two decades. That volatility and uncertainty, in turn, hinder investment and growth prospects.

Both countries serve as a reminder that without macroeconomic stability, including low inflation and manageable public debt, growth beyond boom-and-bust cycles is unattainable. The experience of Ecuador serves to underscore an additional point familiar to students of the economies of Southern Europe: the absence of a local currency, and the possible monetary discipline that brings, does not guarantee fiscal policy will be prudent. If anything, the opposite may be true, as large fiscal deficits can go on for extended periods without inflation and depreciation that can serve as political economy deterrents to the habits of spendthrift politicians.[10]

10 For a theoretical treatment of this point, see Tornell and Velasco (2000).

Macroeconomic stability but declining growth: Colombia, Chile, Peru, and Uruguay

In the midst of a region known for its macroeconomic instability, at least four countries—Chile, Colombia, Peru, and Uruguay—have managed to lower inflation (figure 17) and consolidate fiscal accounts (as has Mexico, which has special features that merit separate treatment). They are also open economies with a predictable investment environment. These nations experienced a period of fast growth after trade liberalization and macroeconomic stabilization, but that period was short-lived. As figure 18 shows, growth has been declining. Why is it that these stable, open economies do not manage to grow on a sustained basis?

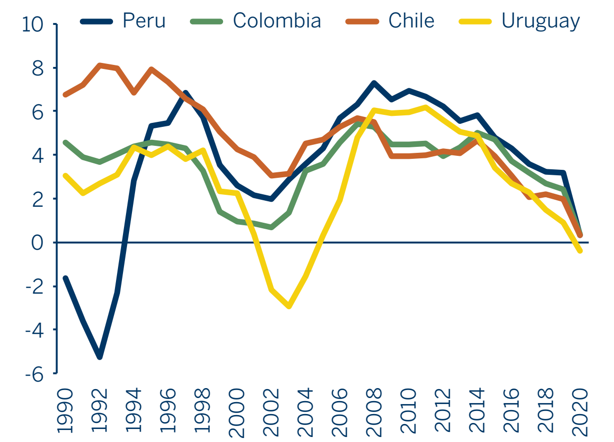
One (optimistic) answer is that the decline is not secular but cyclical, and growth will return once global conditions improve after the pandemic, the war in Ukraine, and the inflationary spurt. There is evidence to the contrary, however. We saw in figures 5 and 6 that trend rates of growth declined in the decade ending in 2020 relative to previous decades. In Chile, perhaps the country with the strongest policy framework in the region, a team of independent experts convened by the Ministry of Finance estimates every year what the country's sustainable rate of growth is, given investment and productivity performance. In the mid-2000s, that figure was estimated at around 5 percent; by contrast, the most recent estimates barely reach 2.3 percent. That is to say, in less than two decades, Chile has lost more than half of its capacity to grow (DIPRES 2022).

An alternative interpretation is that the growth slowdown was to be expected, as these countries rise in per capita income—what economists label "the convergence hypothesis," whereby nations grow less as they approach developed status. This view carries some truth. These four nations are no longer poor (in fact, Colombia and Peru are classified as upper middle income by the World Bank, while Chile and Uruguay are high income), and therefore economic theory would suggest that returns on investment should be declining at the margin. But the difficult question is why the decline has happened so quickly. In East Asia, the fast-growth episode lasted decades, while in South America it lasted just over a decade. In addition, the slowdown came earlier in the per capita income scale; even successful Chile and Uruguay seem to have stopped growing quickly while still much less rich than Taiwan or South Korea.

A third hypothesis is that the policy environment has deteriorated in these countries, and as a result the growth performance has deteriorated, as well. Fix the policy environment, is the implication, and growth will return. Again, there is a grain of truth in this view. Colombia and Peru do not perform especially well in the World Bank Governance Indicators, as figure 19 shows, and Chile has slipped somewhat in recent years. All three countries

Figure 17. CPI inflation, Peru, Colombia, Chile, and Uruguay, 1990–2020

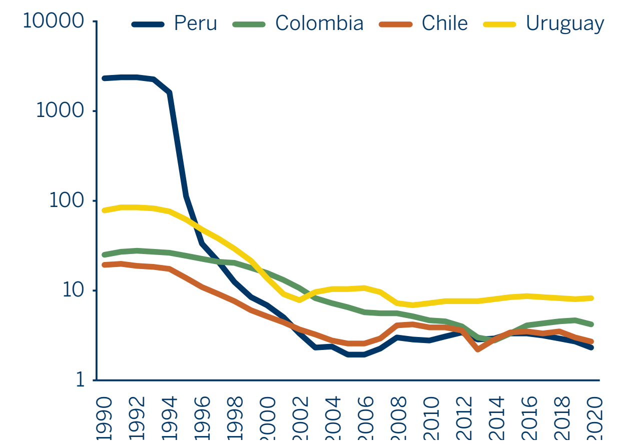
Rolling 5-year average, logarithmic scale



Source: IMF *World Economic Outlook April 2023.*

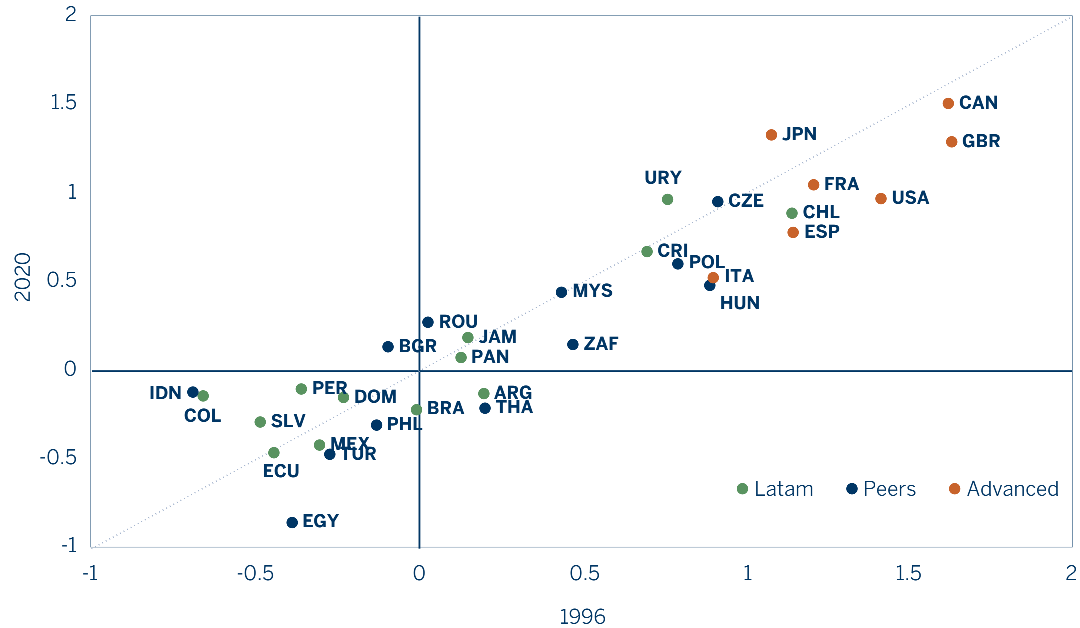
Figure 18. GDP growth, Peru, Colombia, Chile and Uruguay, 1990–2020

Rolling 5-year average, %



Source: IMF *World Economic Outlook April 2023.*

Figure 19. World Bank Governance Indicators, 1996 and 2020



Source: World Bank 2020.

have recently gone through periods of mass, sometimes violent, street unrest. In contrast, in Chile and Uruguay, the policy and institutional environment remains similar to that of the Czech Republic, more benign than other peer nations, and better than that of advanced nations like Italy or Spain. And yet, their economies are failing to grow on a sustained basis.

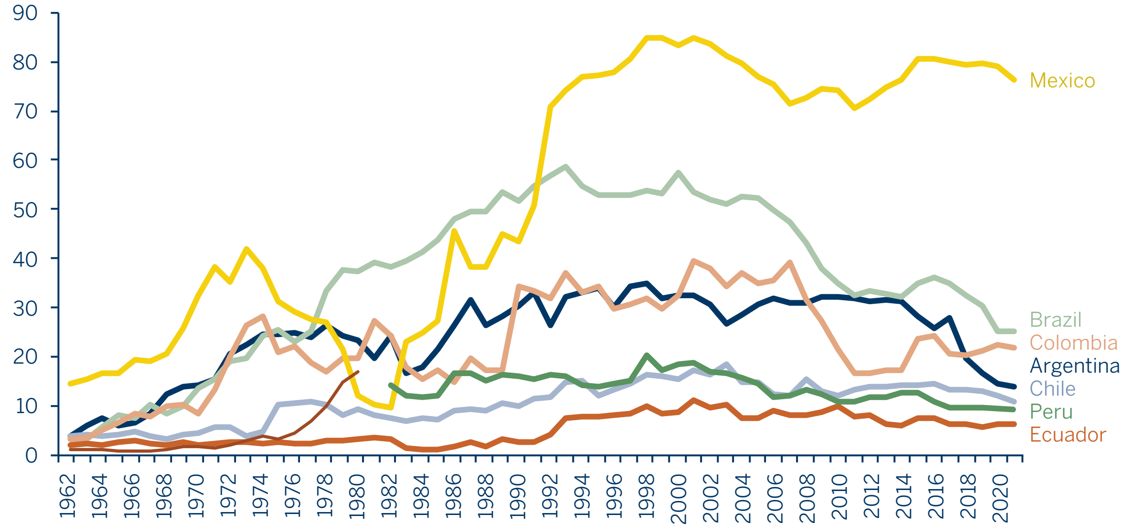
In theory, businesses should continue investing as long as returns exceed the cost of funds. The world is coming out of an extended period during which the cost of funds was abnormally low, yet investment in these four nations was modest. So why are there not enough private sector investment projects with above-the-bar returns, particularly in the tradable sector? One answer involves market failures involving externalities or coordination failures. Another is government failures involving poor infrastructure and mediocre provision of the public goods—from regulatory agencies to sector-specific inputs—that businesses need to grow and succeed. For these reasons and others, in Chile, Colombia, Peru, and Uruguay economic stability has been necessary but not sufficient to fuel sustained economic growth.

Open economy, many reforms, new exports, low growth: the unique case of Mexico

In 1939, Winston Churchill defined Russia as "a riddle, wrapped in a mystery, inside an enigma." When it comes to economic growth, something similar could be said of Mexico. The country embodies a growth paradox: it has enjoyed over two decades of macroeconomic stability; it is an open economy exporting mostly manufactures with a high degree of complexity and embedded in the value chains of North America; exports account for 40 percent of GDP and manufactures for 80 percent of total exports (see figure 20); it has developed a diversified manufacturing sector, with sophisticated production and assembly of electronics and automobiles; it is the 10th largest exporter in the world of information technology goods, with a total value exported not far from that of the United States; the country ranks 20th out of 133 countries in the *Atlas of Economic Complexity*, just behind China and ahead of Belgium, Denmark, Poland, Malaysia, and the Netherlands. Yet, growth has stagnated.

Low levels of productivity have often been emphasized as the main culprit of modest growth. But productivity

Figure 20. Exports of manufactures, selected Latin American countries, 1962–2020
Percent of merchandise exports



Source: World Bank Development Indicators.

is itself an endogenous variable—or, alternatively, a summary statistic that reflects resource misallocation and economic distortions. The challenge is to understand the causes of that misallocation. As we saw above, recent studies have emphasized different factors, such as factor misallocation, incentives for labor market informality, blocked access to finance, barriers to the diffusion of internet technology, inefficient location of firms, high costs of electric power, overregulation and corruption, and low quality of education.[11] Despite the abundant literature on the topic, there is no consensus on a single variable that explains Mexico's stagnant productivity and, therefore, its poor growth performance.

Yet three issues do stand out in Mexico as potential deterrents to growth dynamics. The first is that there is not one Mexico, but two: the Northern and Central States, and the South. The North and Center have much better infrastructure, more abundant social services, and higher quality of education than the Southern portion of the country. The productivity gap is huge between the two regions and, sadly, seems to be increasing. The hard question is related to the underlying political economy: what is it about Mexican politics that yields such an asymmetrical allocation of public goods and services across the different regions of the country? Given this massive asymmetry, it is not surprising that firms invest mostly in the North and Center, giving rise to the observed productivity gap. A related hypothesis, already mentioned, is that of a regional level growth trap: firms do not invest because they do not have access to complementary public inputs and services (ranging from schools and roads to security), but because firms do not invest, regional and local governments do not have access to the revenues needed to provide those complementary public inputs.

The second factor is the rise in "narco-violence" in the last two decades. The number of homicides, missing people, extortions, and violent acts has spiked, taking a toll on economic activity. According to the 2022 Global Peace Index (Institute for Economics and Peace 2022), the direct economic cost of violence (costs resulting from murders; violent crimes; private protection expenses; and military, judiciary system, and jailing expenses) is estimated around 4 percent of GDP. Bel and Holst (2018) calculate that a one standard deviation increase in the

11 Relevant papers include Alvarez (2019); Busso, Levy, Torres (2019); Hanson (2010, 2012); Iacove et al. (2022); Levy (2018); Levy and López-Calva (2016); Maravalle and González Piandella (2022); and Misch and Saborowski (2018).

murder rate is associated with a decrease in growth of 1.21 percentage points.[12]

Moreover, cartels have morphed and are now involved in the opioids crisis in the United States and increasingly engage in human trafficking—including the recent surge in migration from Central America to the Mexico-U.S. border. The policies of the current Mexican administration have done nothing to curb the violence and influence of the cartels, and have allowed those organizations to assume the functions of government in many municipalities, while extorting businesses and blocking trade routes. This, in turn, translates into growing economic distortions and costs for the affected populations.

The third factor is the recent deterioration in institutional capacity and in the quality of public administration. Budget cuts and political threats against autonomous state agencies (the National Statistical Institute and the Federal Electoral Commission, among others) have caused the exit of qualified personnel and policy paralysis, which could have serious implications for growth and stability in the medium term. On the positive side, there has been substantial pushback from public opinion, which has acted as an important counterweight against initiatives to concentrate political power in the hands of the administration.

In short, the riddle of slow Mexican growth does not have a single answer. At the same time, yet another long list of actions or reforms to be taken is not helpful, just as a reloaded Washington Consensus[13] with more recommendations like the ones Mexico has already implemented, will not jump-start growth. There are, however, three specific policy initiatives that follow from the analysis above that have strong potential.

First, deploy additional federal resources into public investment in an effort to reduce the regional gap in infrastructure and public services, so that the South begins to approach North/Central levels of provision. Second, replace the current hands-off attitude with an effort to tackle the increased drug-cartel-induced violence. Closer cooperation between the United States and Mexico is key to address issues such as migration, arms trafficking, and drug violence, and to deescalate conflicts and reduce the influence of the cartels. Third, end current policies that threaten the independence of autonomous state agencies, and instead strengthen the institutional framework and the rule of law. This is essential to increase citizen trust and business confidence, and to restart private investment flows.

Mediocre macroeconomics, micro-meddling, captured state: The unique case of Brazil

From 1950 to 1980, Brazil's GDP per capita gained relative to the United States. Since the 1980s, however, the country has been backsliding, and today income per capita stands at barely 20 percent of U.S. levels. Part of the backward movement was due to the "lost decade" of the 1980s, and since then, growth has remained mediocre, with short growth spurts followed by relapses. In fact, Brazil had negative per capita income growth in two of the last four decades (the 1980s and 2010s). For a country that once grew quickly, this is a calamity.

Again, there is no shortage of possible explanations for this performance: protectionism; underinvestment in infrastructure; education that gains in coverage but lacks quality; labor markets with widespread informality (as much as 40 percent employment) and a prevalence of fixed-term contracts and high turnover; widespread subsidies and tax breaks designed to serve the interests of the corporate and labor interests that have captured the state; heavy bureaucracy in many areas, with weak contract enforcement and corruption. The combination is known locally as *custo Brasil* (Brazilian cost), and rightly so.

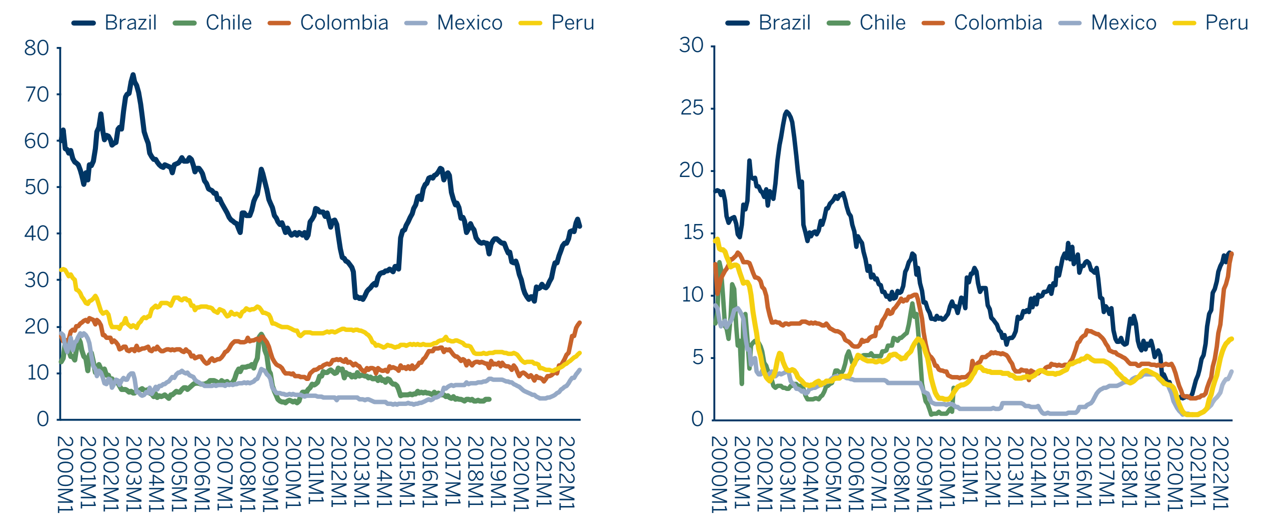
But one overarching problem seems likely to be the most binding constraint holding back growth, and that is endemic budget deficits, associated with low national savings and unusually high real interest rates. Figure 21 shows the lending and deposit monthly interest rate for Brazil, Chile, Colombia, Mexico, and Peru for 2000–22. As the figure shows, Brazil is an outlier, with sky-high

12 Cabral, Mollick, and Saucedo (2016) report that the rise in crime affects labor productivity; Ashby and Ramos (2013) found organized crime deters FDI in financial services, commerce, and agriculture; and Enamorado, López-Calva, and Rodríguez-Castelán (2014) found a negative impact of drug-related homicides on income growth at the level of Mexican municipalities.

13 The Washington Consensus, created in 1989, is a 10-point, market-oriented economic reform package for developing countries in economic crisis that was formulated by Washington-based institutions including the International Monetary Fund, the World Bank, and the United States Department of Treasury.

Figure 21. Monthly real interest rates; Brazil, Chile, Colombia, Mexico, and Peru, 2000–22

Panel A. Lending rate *Percent per annum* — **Panel B. Deposit rate** *Percent per annum*



Sources: International Financial Statistics, World Bank. Real interest rates using effective CPI Index, International Financial Statistics April 2023.

interest rates even when compared to the traditionally high-interest-rate Latin American region.

Fiscal responsibility ceased in 2014–15. A collapse in confidence followed and, despite the approval of some important reforms since then, the fiscal problem is yet to be corrected. High taxation and negative public savings continue to have an adverse effect on national savings. In this context, increases in investment then lead to higher interest rates, a growing current account deficit, or both, and therefore prove short-lived.

In this interpretation, Brazil will not be able to grow on a sustained basis until it fixes its secular fiscal problem. And since the overall tax burden is already at one-third of GDP, the necessary fiscal adjustment will have to start from the always challenging spending side of the ledger. But leaders cannot please everyone simultaneously. Every area of potential adjustment is "owned" by some influential group. There is no path of least resistance.

The difficulty, ultimately, is political, and it underscores the country's challenging political economy. Brazil's inequality and pattern of economic and social frustration have long provided fertile ground for left-wing populism. Now the country must also contend with the emergence of a highly popular far-right movement, which promotes extreme polarization. The danger is that political conflicts will eventually cause episodes of institutional instability. In this environment, volatility and uncertainty depress private investment even further. Slow growth is the predictable—and persistent—outcome.

Growth challenges—and also opportunities

But that is not the end of the story for the region. Not everything is a challenge or a constraint. Changes are afoot in the world economy that could have positive side effects on Latin America. What follows is a brief review of those ongoing transformations.

Start with decarbonization. Lowering emissions will require massive infrastructure investment—in power generation and transmission, energy-efficient housing, roads and public transport, new ports, and airports—and it is not clear where the money will come from. But if only a portion of the plans multilateral lenders are announcing come to fruition, there will be tens of billions of dollars or their equivalent in public money that emerging and developing economies can access, plus additional significant sums in partial guarantees and de-risking arrangements intended to spur private capital flows. This presents a huge opportunity: green investment can create jobs and speed up growth.

In addition, Latin America is a sunny, windy, and (in places) water-abundant region. It can be competitive in solar, wind, and hydropower generation. So far, that output has been for domestic consumption only or, in a couple of cases, for selling to neighboring countries that are connected to the local grid. Hydrogen technology could change all of that and turn the region into an export powerhouse, peddling green energy the world over. The implications for growth, jobs, and incomes could be staggering. And because bottling and transporting hydrogen could well remain costly, energy-intensive industries will want to locate close to sources of green and reasonably inexpensive energy. This will be an additional new opportunity for the region.

As U.S. and Canadian companies redesign their network of suppliers, nearshoring and friendshoring could also be a boon for Latin America. Mexico and to some extent Central America took advantage of the rise of value chains. South America never did. Mexico is already joining a revamped network of suppliers intended to replace firms based in China or elsewhere in East Asia. Could Panama, Colombia, and the countries to the south also join in? Could this be the opportunity for South America to become part of the North American value chain and to export intermediate inputs and components, like Mexico, Malaysia, or Vietnam already do?

Finally, there is the next great unbundling in international trade. Baldwin (2018) has described globalization as a sequence of "great unbundlings." The first came in the late 19th century when steam power cut the expense of moving goods internationally. The second came in the late 20th century when information technology radically lowered the cost of moving ideas across borders. A third great unbundling could soon occur, predicts Baldwin (2020), as digital technology makes it cheap and easy to move *people* across borders—without ever having to leave one's bedroom, office, or kitchen.

Over the last quarter century, Latin American countries have massively increased enrolment in tertiary education. But those newly minted professionals do not always find jobs in which they can put their new skills to use. That could be about to change. Peruvian architects can design buildings in Beijing, Argentine consultants can provide advice for firms in Chicago, and Latin American firms in the transport and financial services industry can become extra-regional exporters. Traditionally, globalization meant export of goods. But now, the era of service exports is here. The Zoom revolution is yet another opportunity for Latin America.

It is one thing for opportunities to arise; it is another to ensure that nations seize those opportunities. For this purpose, business as usual will not do. Take the green revolution: countries with clean energy potential, or endowed with rare earths or key minerals like lithium, will have to improve their investment and regulatory framework if they are to get the needed investment. The experience of a country like Bolivia is instructive: despite being endowed with massive lithium reserves, today it barely exports the element, in contrast to neighboring Chile and (increasingly) Argentina.

Income distribution, poverty, and welfare: Gains and losses

A common narrative links rising inequality with citizen discontent, street protests, and the rise of populism in Latin America. When usually tranquil Chile experienced an episode of intense unrest and violence in late 2019,[14] the *Financial Times* (Mander 2019) concluded that "Inequality in 'stable' Chile ignites the fires of unrest." When in 2022 leftist Gustavo Petro was elected president of Colombia, *The Economist* (2022) ran a story entitled "Inequality in Latin America is fueling a new wave of populism."

Clearly, income inequality is a serious problem that has the potential to make many citizens angry. But the economic and political reality is much more complex than those headlines suggest. For starters, until the pandemic, income inequality in Latin America was declining, not increasing. And rising citizen discontent cannot be explained with an explanatory variable that for nearly two decades was declining.

Figure 22 shows the Gini coefficient for Latin America and the group of peers for 2006 and 2018. Two facts stand out. On the one hand, Latin American nations are much more unequal than all their peers except the Philippines, which endures Latin American Gini levels. On the other hand, during that 12-year period, inequality fell in every Latin American country in the sample. By contrast, among the comparator nations inequality increased in Hungary, Indonesia, Bulgaria, and Turkey.

It is well documented that inequality decreased in the region in the first two decades of the century.[15] The Inter-American Development Bank (2022) concludes, in a recent blog, that "in 2019, the region experienced the lowest level of inequality in the past 30 years."

Why did this decline take place? Lustig, López-Calva, and Ortiz-Juarez (2013) point to two main factors: a reduction in the wage skill premium, and "more robust and progressive government transfers." The wage premium between earners with a high school education and those with a university education fell mostly because of the fast increase in higher education enrolments over the last two decades. As the supply of professionals grew faster than the demand for their services, the relative wage of university-educated professionals declined.[16]

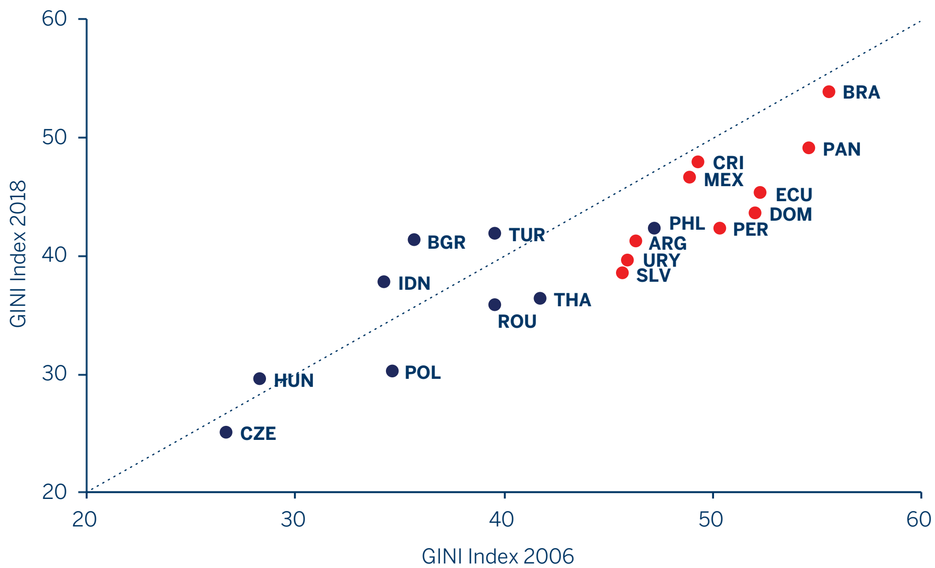
The second factor—"more robust and progressive government transfers"—that is, larger redistributive government expenditures—occurred mostly during the commodity boom, as high raw material prices enlarged government revenues and allowed governments to spend more in transfers and subsidies to low-income

14 Colombia, Costa Rica, Ecuador, and Peru also experienced street unrest at roughly that time.

15 See, for instance, López-Calva and Lustig (2010).

16 Some studies also find that relative returns fell because of a shift in demand away from skilled labor.

Figure 22. Gini Index, Latam and peers, 2006 and 2018



Source: World Development Indicators.
Note: Latam = Latin America.

households. Well-known cash transfer schemes in Brazil (*Bolsa Familia*), Mexico (*Oportunidades*), and several other countries are examples of this trend. Pension reforms that created government-funded minimum pension schemes in Argentina and Chile, among others, also point in that direction.

An obvious caveat to this positive assessment is that the data the World Bank uses to compute Gini coefficients comes mostly from household surveys, and therefore tend to underestimate capital incomes, which accrue mostly to high-income households. Using administrative and tax records, the World Inequality Database has tried to complete the picture, especially with respect to the incomes of those at the top of the income distribution.

Figure 23 shows the evolution of the top 1 percent's share of income distribution for both Latin America and the peer group between 1990 and 2020. Predictably, that share is substantially higher in Latin America than in the comparator group. Moreover, the share is roughly constant for the peers, while it has been increasing (with some ups and downs) in Latin America since about 2000. Yet the rise is not large: from 21 percent to (roughly) 24 percent.

Another important caveat is that preliminary evidence suggests that some of the previous gains in inequality reduction may have been undone by the pandemic. This has no bearing on the possible explanations for the widespread surge in street unrest in 2018–19 (which of course happened before the arrival of COVID-19), but it does raise questions about the future course of income distribution—and politics—in the region.

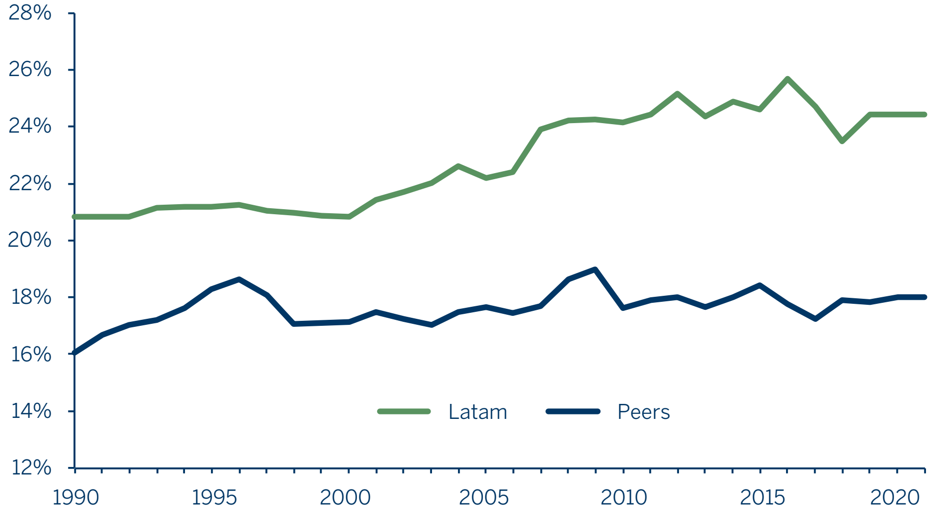
Chile conducted a national household survey in late 2020, after some of the worst effects of the pandemic had already been manifested.[17] The poverty rate rose to 10.8 percent, compared to 8.6 percent in 2017. Even more strikingly, the Gini coefficient rose from an already high 0.488 to an even higher 0.510, mostly caused by a collapse in income of the bottom quintile (and especially the bottom decile), as lockdowns (which Chile rigorously enforced) eliminated many kinds of informal work. Strikingly, the monetary income of the bottom decile dropped to just 0.1 percent of total monetary income.

The results for several other countries are also quite negative, with different measures of inequality increasing in a majority of Latin American countries. A recent Inter-American Development Bank paper (Acevedo et al. 2022) computes the changes in the Gini coefficient between around 2019 (the last pre-pandemic measurement) and 2020, using a definition of household incomes

17 Ministerio de Desarrolo Social y Familia, Gobierno de Chile 2021, July.

Figure 23. Top 1% share of income distribution, 1990–2020

Simple average by group



Source: World Inequality Database.

that includes government taxes and transfers. The largest increases in inequality occurred in Colombia, Peru, Bolivia, and Chile, with Ecuador, Brazil, and Costa Rica also experiencing a rise in the Gini. Peru and Chile are among the most affected, even though they were among the countries that expanded government spending and cut taxes the most (figure 3).

What about other indicators of citizen welfare? One useful data source is the United Nations Human Development Index (HDI) which, in addition to income, incorporates health, education, and other factors relevant to well-being.[18]

Figure 24 shows the evolution of the HDI for the average of Latin America and the peer group between 1990 and 2018. It is striking that the performance of both groups is so similar, both in level and in the evolution of that level through time. The index runs from zero to 1, and the gap between the two regions never exceeds 0.02. The period begins with a gap of around 0.65 in 1990 and rises to between 0.75 and 0.80 in 2018. So, despite the substantially greater inequality in Latin America, access to health and education results in human development levels similar to those of the comparator group.

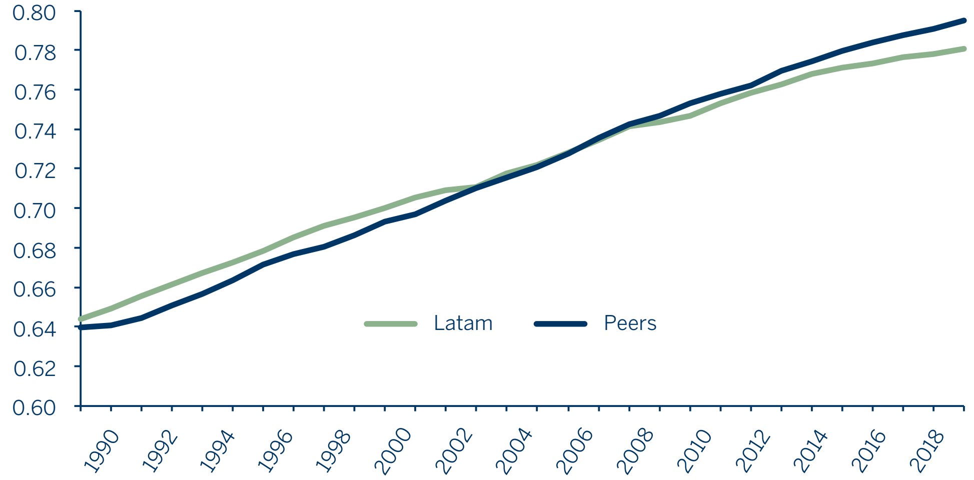
That is the good news. The bad news is that since the global financial crisis, the performance of the two groups seems to have begun to diverge, with the peer group displaying a slightly faster pace of improvement in human development. Interestingly, the budding divergence seems to follow mostly from the worsening in the growth performance of Latin America relative to the peers, and not from a relative decline in health and educational indicators.

Summarizing, the recent performance of Latin America with respect to poverty, income distribution, and human development is not stellar, but it is also not as dismal as critics and sceptics often suggest. The region did experience two decades (essentially, the first two decades of the 21st century) during which both poverty and inequality declined, while measures of human development rose on a sustained basis in most countries.

But the pandemic and its aftermath seem to have put an end to that period of social advancement, while the region's diminished capacity to grow pares back both the rise of real wages and the expansion of government revenues and, hence, of redistributive fiscal spending. How this change will affect the future political economy of

18 The health dimension is assessed by life expectancy at birth, and the education dimension is measured by the mean of years of schooling for adults aged 25 and older and expected years of schooling for children of school-entering age. The standard-of-living dimension is measured by gross national income per capita. The HDI uses the logarithm of income to reflect the diminishing importance of income with increasing gross national income. The scores for the three HDI dimension indexes are then aggregated into a composite index using the geometric mean.

Figure 24. Human Development Index, 1990–2019
Simple average by group



Source: United Nations Development Programme.
Note: Latam = Latin America.

Latin America remains to be seen. There is a risk that in an environment of higher world interest rates and sharply reduced fiscal space, the region could relive the unhappy experience of the 1980s, a period in which cuts in public investment and social spending were used to balance the fiscal books. Tax reform leading to enhanced government revenues could be one way out of this conundrum, but the political economy of such a process is far from easy.

We close this section by revisiting one key issue: If the first two decades of this century were a period of improving social conditions and gradually falling inequality, why did it end with street demonstrations that often turned violent? And why (as we document in the next section) was it also a period of declining confidence in governments, parliaments, and parties?

These are difficult questions the comprehensive answers to which are beyond the scope of this paper. But note that improving social conditions (at least for a while) and deteriorating political perceptions can coexist. In fact, there is a long and distinguished tradition in the social sciences that argues that often they do coexist.

In *Democracy in America* (1840), Alexis de Tocqueville wrote: "The hatred that men bear to privilege increases in proportion as privileges become fewer and less considerable, so that democratic passions would seem to burn most fiercely just when they have least fuel. [...] When all conditions are unequal, no inequality is so great as to offend the eye, whereas the slightest dissimilarity is odious in the midst of general uniformity. [...] Hence it is natural that the love of equality should constantly increase together with equality itself, and that it should grow by what it feeds on." That is the de Tocqueville paradox: as social conditions and opportunities improve, social frustration can grow more quickly.[19]

One reason why frustration rises is that as societies become more fluid, and access to communications technology (including social media) increases, those in the middle and the bottom of the income scale become more aware of "how the other half lives," a realization that prompts rising expectations and rising social demands. Moreover, other kinds of gaps, such as measures of inequality of opportunity—which capture how much income inequality can be attributed to factors beyond a person's control, such as race, gender, place of birth, and family background—become more evident and painful.

Take the much-improved access to higher education which, as we saw above, is causing wage premia to contract in many countries. This change is good for society as a whole, as human capital is accumulated, and measures of income inequality gradually are reduced. But for

19 Quoted in Ferreira and Schoch (2020).

the members of the transitional generation, things need not look so rosy. They often chose to attend university expecting a high wage premium and are disappointed to be confronted by a different reality. In addition, many attended fee-charging institutions and borrowed to pay those fees, so find themselves with a mountain of student debt when they graduate. And once they start looking for a job, new graduates often face discrimination and glass ceilings. The result is a generation that is better educated and has higher incomes than any other generation in Latin America's history—but is also frustrated and bitter.

The region's problematic political economy

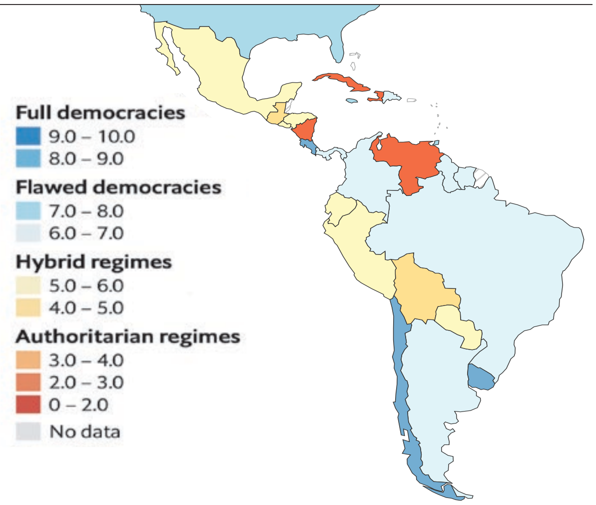
Democracy in Latin America

In early 2023, the Economist Intelligence Unit published its 2022 Democracy Index. The score of Latin America and the Caribbean fell from 5.83 (out of a possible 10) in 2021 to 5.79 in 2022. In fact, the region's score has been either stagnant or falling every year since 2008, when it peaked at 6.43. Today, according to the Economist Intelligence Unit, only Costa Rica, Chile, and Uruguay are full democracies, with scores of 8 or above. At the other end of the spectrum, Cuba, Haiti, Nicaragua, and Venezuela are fully authoritarian regimes, with scores of 3 or less. The rest fall in between, with Argentina, Brazil, Colombia, Panama, Jamaica, Guyana, Suriname, and Trinidad & Tobago classified as flawed democracies, and Mexico, Ecuador, Paraguay, and Peru (plus a number of others) as hybrid regimes.[20]

Those results suggest a backsliding of democracy and its institutions in the region. Still, in the Economist Intelligence Unit index, Latin America and the Caribbean remains the most democratic region outside North America, Europe, and Oceania—better, that is, than Africa, the Middle East, and Asia.

The Economist Intelligence Unit is not the only international source that has recently delivered worrisome news about the state of Latin American democracy.

Figure 25. Economist Intelligence Unit Democracy Index, Latin American countries, 2022



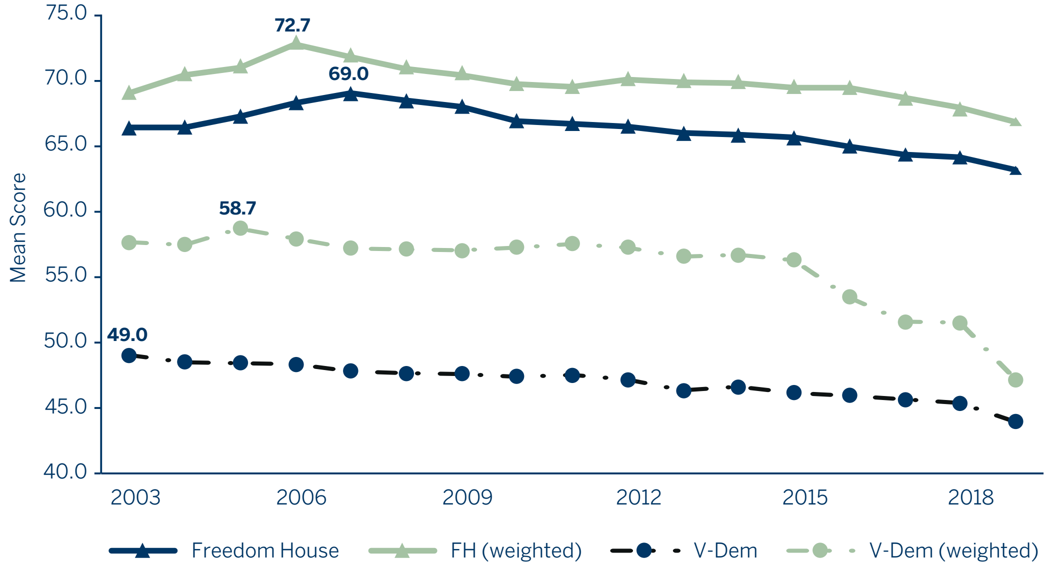
Source: Economist Intelligence Unit.

Both the Varieties of Democracy (V-Dem) project and Freedom House also compile ratings that track levels of democratic performance. Figure 26 shows V-Dem's average Liberal Democracy score for the 20 Latin American countries (rescaled from zero to 100) and

20 Belgium, Estonia, Italy, Poland, Portugal, and the United States are also classified as flawed democracies, so there is no great stigma associated with the label.

Figure 26. Average democratic performance, 2003–21

Mean Score



Sources: Freedom House; V-Dem; World Bank.

Freedom House's average score on its zero to 100 scale for 2003 (the first year available with that scale) to 2021. On both scales, a higher score shows a better performance. We show arithmetic and population-weighted averages.

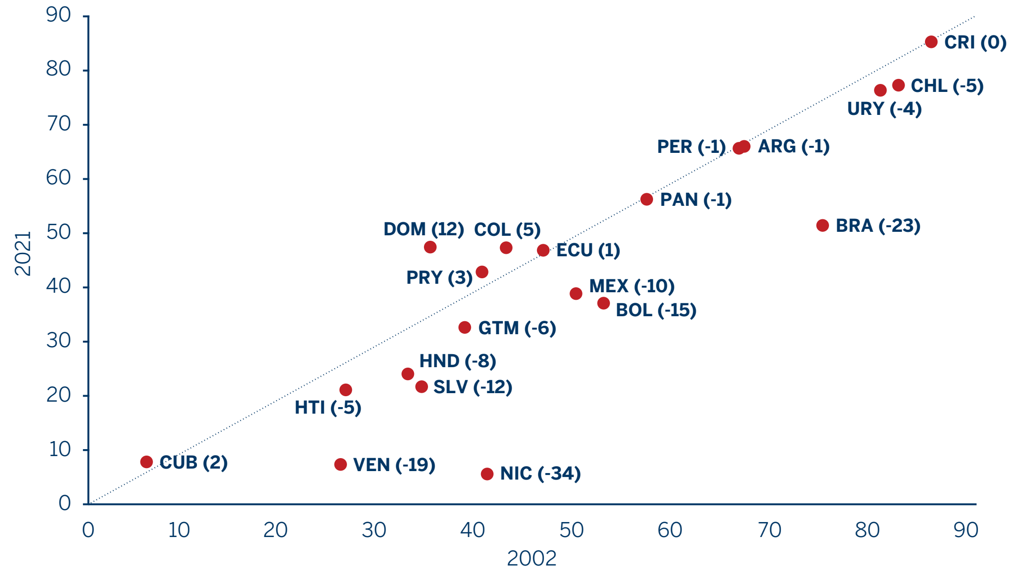
Both sources show a sustained decline in the quality of democracy, after a peak that occurs in the first five years of data. The weighted V-Dem series shows a particularly sharp decline in 2018, corresponding to the deterioration of both Mexico and Brazil, the two most populous nations in Latin America.

Averages, even when weighted, obscure interesting cross-country variation. To look more deeply into individual country performance, figure 27 shows the V-Dem index for two years, 2002 and 2021. Only five countries have an improved performance, and in only one case (the Dominican Republic) is the improvement significant (plus 12 points). On the other side of the ledger, of the 14 nations that display declining quality of democratic practice and institutions, six (Brazil, Bolivia, El Salvador, Mexico, Nicaragua, and Venezuela) experienced drops of 10 points or more, with Brazil (-23), Nicaragua (-34), and Venezuela (-19) in free fall. Even poster children Chile and Uruguay show slight declines, with Costa Rica stable.

Recent events would also seem to lead to a pessimistic assessment of the prospects for democracy in the region. In recent months, Peru's president attempted to dissolve Congress, Argentina's vice president was convicted of fraud, and supporters of Brazil's outgoing leader unleashed an attack on government buildings in Brasilia (*New York Times* 2022; NBC News 2022; *The Guardian* 2023). The current administration in Mexico has embarked on a process of systematic weakening and defunding of certain institutions. Add the consolidation of dictatorships in Venezuela and Nicaragua and the Salvadoran president's announcement that he will seek reelection despite constitutional limits, and it would seem that democracy is in trouble in Latin America (Velasco 2022).

But a closer look also reveals a somewhat different picture. The Peruvian president who tried to shut down Congress was peacefully removed by it. The events in Brasilia were shocking, but the person voters elected to replace outgoing president Jair Bolsonaro, Luiz Inácio Lula da Silva (known as Lula), remains in office. Similarly, Argentina has plenty of other problems, but the country does have judges who can indict powerful government officials. Amid the corruption scandals of the 2010s, former Brazilian President Fernando Henrique Cardoso famously quipped that, "In the past…everyone knew the names of the generals who might stage a putsch, whereas

Figure 27. Country democratic performance, V-Dem 2021 Liberal Democracy Score, 2002 and 2021



Source: Mainwaring and Pérez-Liñán 2023.

now everyone knows the names of the judges who pursue allegedly corrupt officials.[21]

Argentine Vice President Cristina Fernández is not the only Latin American leader clashing with the courts. In Mexico, President Andrés Manuel López Obrador has accused judges of defending the interests of unidentified "groups" instead of "the people" (Viña 2022). But when he recently tried to change the constitution to weaken the Federal Electoral Institute, people took to the streets in Mexico City to oppose the proposed change. Though he could not muster the supermajority needed to amend the constitution, President López Obrador garnered enough votes to pare back the Institute's autonomy, slash its budget, and remove many members of its current staff. Opposition parties will take their challenge to the Supreme Court, arguing the bill violates the constitution.

In late 2019, Chilean democrats managed to end violent street protests by launching a process of constitutional reform. While the first attempt at writing a new constitution failed, Congress recently agreed on the procedures that will govern a second attempt. A new constituent assembly was elected in May, and by the end of 2023 Chile will likely have a new constitution to replace the one written in 1980, during the dictatorship of General Augusto Pinochet.

These are clearly not the best of times for liberal democracy in Latin America, but they are not the worst of times either. As crises come and go, and continue to buffet the region, the culture and institutions of democracy have proven resilient in a number of countries.

A low-trust, low-institutional-capacity trap?

The fate of democratic governance ultimately depends on the quality and credibility of democratic institutions. And when it comes to the quality of institutions and governance, as measured by the World Bank, the performance of the region is decidedly uneven. Figure 28 shows, for Latin America and the peer group, the 2000 and 2020 average of the World Bank index covering Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.

21 https://www.project-syndicate.org/commentary/latin-american-democracy-strong-peru-brazil-argentina-mexico-chile-by-andres-velasco-2022-12.

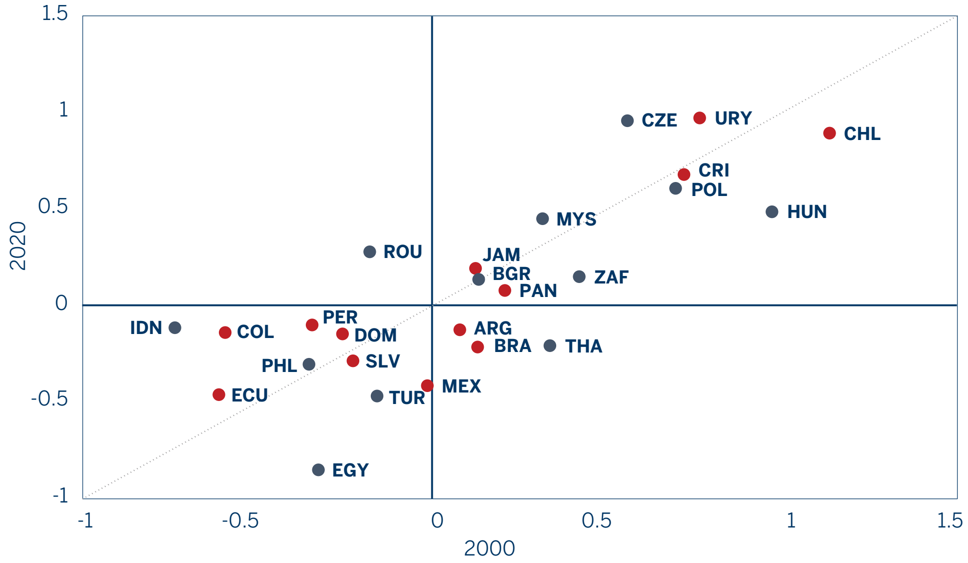
As figure 28 shows, Latin America is not that different in this dimension from the peer group. In fact, the heterogeneity in the quality of governance within each group is remarkable. There are countries with relatively high-quality institutions, such as Chile, Costa Rica, and Uruguay in Latin America, and the Czech Republic, Poland, and Hungary among the peers (though in both Poland and Hungary, governing parties have also attempted to weaken democratic institutions). And there are also examples of poor institutional quality in both groups: Ecuador and Mexico in one case, Egypt and Turkey in the other.

And while there are some Latin American nations above the 45-degree line, suggesting they have improved since 1996, there are a number of others that show movement in the opposite direction. Among those improving are Colombia, Peru, and Uruguay, and, marginally, Ecuador, Jamaica, and the Dominican Republic. Among those showing a declining performance are Argentina, Brazil, Mexico and, remarkably, Chile.[22] The decline in Chile is surprising because it has long been regarded as a regional leader in institutional quality. Unpacking the components of the index, it turns out that since 2015, Chile's decline has been across many sectors but especially in Political Stability, Government Effectiveness, Regulatory Quality, and Rule of Law.

Closely related is another troublesome feature of the region's political economy: low and (in some dimensions) declining levels of trust—whether interpersonal trust or trust in institutions. Figure 29 shows the standard indicator of interpersonal trust[23]—that is, the share of people who answer that most people can indeed be trusted. Both Latin America and the peer group exhibit low interpersonal trust, but it is systematically lower in Latin America, by a margin of 5 to 10 percentage points. Moreover, interpersonal trust has been declining in both regions, with only one in 10 people reporting in Latin America that most others can be trusted.[24]

The results for trust in government are, if anything, more disheartening. Figure 30 shows the share of people who express "a great deal of trust" in their national government.[25] Figures are low and declining for both Latin

Figure 28. World Bank Governance Indicators, 2000 and 2020



Source: World Bank Indicators.

22 Costa Rica and Panama also posted marginal declines.

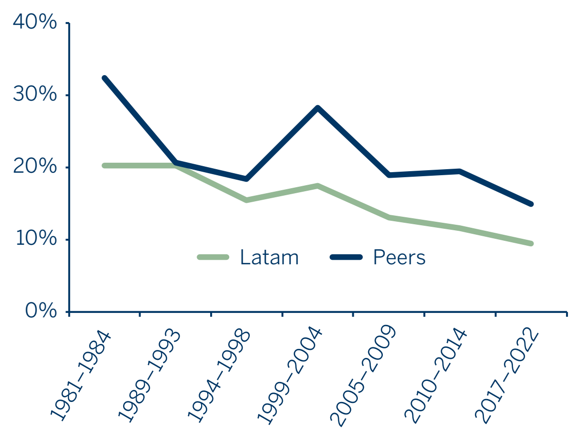
23 *Source:* World Values Survey.

24 In this case, the peer group is incomplete. Data exist for only Egypt, Greece, Hungary, Poland, Turkey, and Ukraine.

25 *Source:* World Values Survey.

Figure 29. Share of people who answer most people can be trusted, 1981–2022

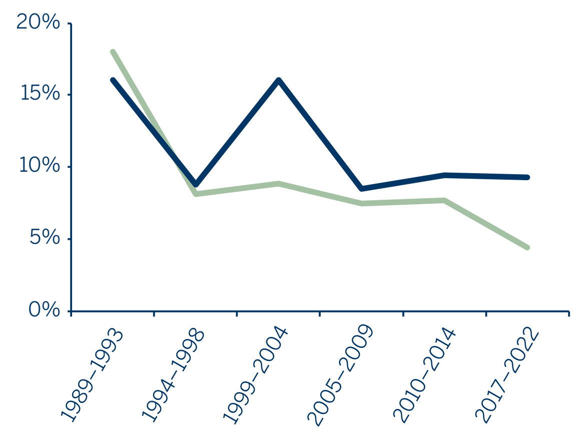
Unweighted average by group



Source: World Value Survey.

Figure 30. Share of people who express high trust in government, 1981–2022

Unweighted average by group



Source: World Value Survey.

America and the peer group.[26] Fewer than one in 20 Latin Americans reports high trust in those in government. Of course, there has been a decline in government trust worldwide,[27] but in Latin America this problem seems particularly acute.

We do not have comparable data for the peers regarding trust (or lack thereof) in public or nongovernmental institutions, but Latinobarómetro provides a fairly long time series (dating back to 1995) for most countries in Latin America. Political parties and parliaments do worst, but media, unions, business groups, and even the Catholic Church endure low trust, which is often in decline. Figure 31 shows the relevant trends for parliament, political parties, and the judiciary. In all cases trust is persistently low, with a slight uptick since 2017.

Latin America is not unique. Survey data suggest a worldwide trend, with both interpersonal trust and trust in government institutions on the decline (Keefer and Scartascini 2022). In turn, low levels of trust are blamed for many social ills. A growing literature claims that lack of trust in government hindered U.S. attempts to fight the coronavirus, while high-trust countries like Iceland and Taiwan were much more successful at controlling contagion (Elbanna, Hsieh, and Child 2020). One article is even entitled, "The Secret to Coronavirus Success Is Trust" (Schrad 2020). A recent book attributes the gap in pandemic performance between advanced and emerging Europe to a trust-in-government gap between the two regions (Nagy-Mohácsi and Takáts 2023).

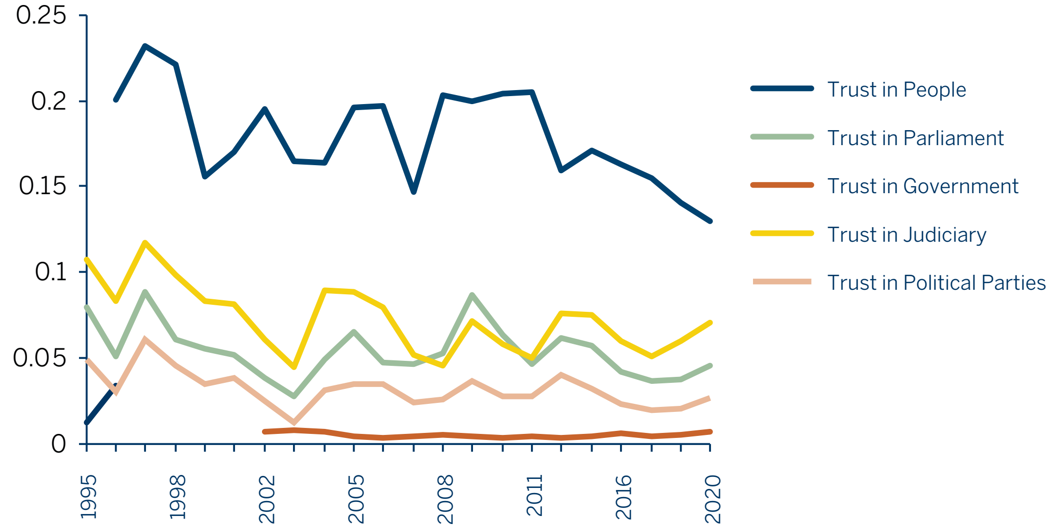
Lack of trust is reportedly behind the growing populism in many countries' politics. Algan et al. (2017) find that increases in unemployment during and after the global financial crisis are strongly correlated with a decline in trust in national and European political institutions and with voting for non-mainstream, especially populist, parties. Norris and Inglehart (2019) find populist support is stronger among the working class, the less educated, men, ethnic majorities, the economically insecure, and those expressing political mistrust. Low trust is also blamed for the size and persistence of the informal economy, citizen unwillingness to pay taxes, excessive regulation and red tape, mediocre performance in schools, and slow economic growth, among many other problems (Keefer and Scartascini 2022).

It is quite possible that lack of trust and poor institutional performance are related. The trust people place in an institution depends on many factors, but a key factor is how effective that institution is. The British love the National Health Service because it delivers high-quality health care (waiting times notwithstanding). Americans

26 Again, the peer group includes only Egypt, Greece Hungary, Poland, Turkey, and Ukraine.

27 This is part of the anti-elitist turn of contemporary politics.

Figure 31. Trust in parliament, political parties, and the judiciary, 1995–2020
Average of answers "a great deal of trust"; unweighted average



Source: Latinobarómetro.
Note: Interpersonal trust and trust in government are included for reference.

have rejected attempts to privatize the popular Social Security System for analogous reasons.

But notice also that the effectiveness of a public institution depends crucially on how much trust there is. Doctors at a public hospital can cure disease only if patients trust them, follow their instructions, and use the medicines they prescribe. A national development bank can fund its operations via low-cost deposits if and only if savers are confident their money is safe.

Moreover, if one trusts public health authorities and follows rules on social distancing but no one else does, then one is still susceptible to contagion. If I trust the bank and no one else does, my money is not safe. The confidence one places in an institution matters, but other citizens' confidence matters just as much if not more. This means there is ample scope for multiple equilibria and indeterminacy of outcomes. When it comes to institutional quality and trust, once we all come to believe that our institutions are ineffectual, ineffectual institutions is what we are likely to get. It could be that Latin America is trapped in such a bad equilibrium, with expectations of poor performance, and the accompanying lack of trust.

The need for political reform

Finally, there is growing evidence of deeper, structural problems of constitutional design in Latin America. Political systems have two key features: the nature of the political regime—presidential, parliamentary, or mixed; and the electoral system—majoritarian, proportional, or mixed. This yields four possible permutations, as shown in table 8.

Table 8. Alternative political arrangements

	MAJORITARIAN ELECTORAL SYSTEM	PROPORTIONAL ELECTORAL SYSTEM
Parliamentary Regime	United Kingdom, Canada, Australia	Much of continental Europe
Presidential Regime	United States	Latin America

The combination of parliamentary governance and proportional representation has yielded model democracies in much of continental Europe and Scandinavia. The parliamentary first-past-the-post formula of the Westminster system, copied by Canada and other Commonwealth countries, also works. The United States combines presidential and majoritarian arrangements (single-seat districts in the House, two seats per state in the Senate). Recent troubles notwithstanding, this mixture has sustained nearly 250 years of stable democracy.

And then there is the pairing of presidentialism and proportional electoral systems, which exists only in Latin America. Presidents are elected for a fixed term of office and remain regardless of whether they enjoy a parliamentary majority. And proportional systems, which allocate seats according to a party's vote share, deliver the kinds of fragmented parliaments that Brazil, Chile, Colombia, Ecuador, and Peru have had to endure in recent years.

The practical results of the fixed-term executive/proportional electoral system combination have been exacerbated by the decline of another crucial democratic institution: political parties. Many Latin American countries never had strong and stable parties. In the few that did—Chile, Colombia, Costa Rica, and Uruguay among them—parties are a shadow of their former selves. For example, Chile today has 15 legally constituted parties and a half-dozen in the process of gaining legal recognition. No party or coalition commands a working legislative majority. In 2020, only 7 percent of Chileans expressed trust in parties, which have been described as "hydroponic"—that is, floating above society with no roots in it (Latinobarómetro 2021).

The decline of parties throughout the region is partly the result of well-meaning reforms with unintended consequences. It was once thought that making the electoral system more proportional would better reflect society's increasing diversity; instead, it has produced myriad tiny parties that represent no one. Introducing primaries was supposed to make parties more democratic internally; it did, but at the risk of making them vulnerable to takeovers by outsiders with name recognition. And the gain in transparency brought by campaign finance reform also weakened party discipline, as bosses lost leverage over publicity-seeking parliamentarians.

The problem is not uniquely Latin American. Yale political scientists Frances McCall Rosenbluth and Ian Shapiro have argued that similar reforms in the United States and Europe, meant to "return power to the people," weakened parties and led to "policies that are self-defeating for most voters" (Rosenbluth and Shapiro 2018).

Paradoxically, the closer to the grassroots political power moves, the more disenchanted the grassroots become.

The bottom line is that the "governance deficit" many Latin American countries display is plausibly connected to the unique political arrangements the region has developed. This would seem to be an area ripe for further research and, more importantly, eventual reform.

Conclusions

Latin America's larger economies are stagnating. The problem is decades old but has become deeper and more widespread since the end of the commodity boom. Most countries have grown little during that period; they suffered sharp dips during the COVID-19 crisis, recovered quickly, and now contemplate the prospect of slow growth for the foreseeable future.

There is no single cause for this growth deficit. In some nations—Argentina, Ecuador, and Venezuela among them—little or no sustained growth can be expected until fiscal, debt, and (in some cases) inflation problems are addressed.

Brazil also suffers from fiscal weakness, in the sense that systemic budget deficits have been associated with high real interest rates that are outliers even in a traditionally high-interest-rate region. The resulting low and volatile investment rate remains a binding constraint to sustained growth. At the same time, a host of microeconomic distortions lower rates of return on new capital and further diminish productivity, investment, and growth.

In Mexico, micro-distortions and mis-designed social policies also account for widespread misallocation and low productivity. Sizable reforms and close trade integration with Canada and the United States have had a surprisingly small impact on growth. Other factors, including low investment in physical and human capital in the South of the country, growing violence and lawlessness linked to the drug trade, and a decline in the capacity and autonomy of a number of government agencies, help explain this weak growth performance.

A number of countries elsewhere in Latin America—Chile, Colombia, Peru, and Uruguay among them—have managed to stabilize their macroeconomies and, until the recent global inflationary spike, enjoyed decades of low inflation and (for the most part) financial peace. In those countries, macroeconomic stabilization plus the opening to international trade did unleash high-growth episodes, which raised per capita incomes and brought unprecedented prosperity. But growth slowed long before income levels had converged to those of advanced nations, suggesting that macroeconomic stability is a necessary but not sufficient condition for sustained growth. In all four countries, a growth strategy aimed at overcoming both market and government failures is necessary, with the goal of further diversifying economies and developing new sectors with high growth potential.

Regarding income distribution, the good news is that in the first decade-and-a-half of the 21st century, policies (in part made affordable by the commodity boom), had a substantial effect on reducing inequality and poverty. The bad news is that the pandemic produced substantial backsliding, and countries will now have to recover the lost ground.

The political economy of the region remains problematic. Widespread democratization was a major achievement of the closing decades of the 20th century. But now democratic backsliding is a major concern, with some countries no longer democratic—Nicaragua and Venezuela among them—and others, including El Salvador, displaying increasing authoritarian tendencies.

Among the many nations of the region that remain democratic, institutional design problems render governance difficult. The peculiarly Latin American combination of presidential regimes and proportional electoral systems often yields governments that lack parliamentary majorities, and hence cannot undertake reforms or carry out the changes they promised during electoral campaigns. Voter frustration and disenchantment are the predictable consequences.

Declining trust in institutions is another striking feature of the region's political landscape. Latin America seems to be caught in a low-credibility, low-performance trap. Because citizens do not trust government, law enforcement and adherence to government rules and regulations is weak (widespread evasion of social distancing norms during the pandemic was an example). This means that policies often have poor or unexpected results, closing the circle and confirming citizen distrust. Restoring trust and rebuilding state capacities are two sides of the same problem, whose solution will require a coordinated effort involving both technocratic tinkering and bold political leadership.

Latin America's many deficits will not be overcome unless policies change. But in an atmosphere of polarization and political deadlock, engineering deep and lasting reforms is particularly difficult.

A conceivable path is that mediocre economic and distributional outcomes will continue to poison the well of mutual trust, rendering politics more fragmented, elections more polarized, and the capacity to make tough choices—of the kind that have costs upfront and benefits down the road—even more diminished. That would constitute an economic, social, and political vicious circle. Stagnation would be the norm and, as a consequence, more unrest and distrust would become likely.

There is also the related and unsettling prospect that the region could oscillate between left-wing and right-wing varieties of populism. In Brazil, a majority of voters tired of Jair Bolsonaro's authoritarian tendencies and erratic style of governance and transferred power to an administration at the other end of the political spectrum, but there is little to suggest Lula's government will address Brazil's longstanding structural challenges. In Chile, the left-wing majority in the first constitutional convention produced a deficient text that was rejected by an overwhelming majority of voters. And barely a year and a half after electing the country's most leftist president in decades, the Chilean electorate seems to have swung to the right, awarding the largest block of votes in a new constitutional convention to a brand-new hard-right party. Exactly what this will mean for the prospects of a new constitution in Chile remains to be seen.

Brazil and Chile are just two examples of a broader trend involving voter distrust, ideological polarization, anti-incumbent sentiment, and populistic leanings that seem to be affecting much of the region. But that is not the only imaginable outcome. An alternative path involves skilful political entrepreneurs who assemble coalitions and gather support for key political reforms, including the strengthening of political parties and updating electoral rules to ensure governments will be able to secure the majorities needed to govern. In turn, being able to deliver on the promises made during campaigns would increase voter trust in the system.

Large-scale political bargains are imaginable, in which a strengthening of the region's social safety net and an improvement in the quality of public services—buttressed by both administrative reform and increases in tax revenue in most countries—are coupled with investor-friendly reforms that increase the attractiveness of productive investment, particularly in the export sector. Public service reform, on the one hand, and economic growth and the diversification of exports, on the other, would become explicit and priority goals, commanding the attention of the political class, the state bureaucracy, and the business community.

The advent of new technologies such as green hydrogen, which could be a source of sizable hard currency earnings, might help. The fruits of those technological advances, in turn, could be used to pre-distribute and redistribute income, lessen social tensions, and further increase trust voters place in institutions. In this scenario, little by little, trust would be rebuilt and political capital accumulated of the kind needed to undertake additional politically difficult, growth-enhancing, and public service-improving reforms. That would constitute a social and political virtuous circle. With more economic expansion and social progress, unrest and distrust would become less likely.

Latin America is not condemned to stagnate as its politics continue to deteriorate. The slide can be halted before it becomes irreversible. An alternative path is attainable, but it will require good politicians, good policies, and good luck. The time for change is now, and the urgency is greater than ever.

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