Stabilization, Adjustment and Development in Latin America

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This short presentation has three purposes. The first is to rapidly review the main features of stabilization, with the benefit of hindsight, and to broaden the discussion on macroeconomic stability by adding some considerations on the problems of the current account of the balance of payments and financial stability. The second is to recollect what I consider are the main structural adjustments in the region, in many instances still ongoing, and their expected impact on the long-term rate of growth of the economy. The third is to establish an inventory of the main issues concerning sustainable growth for the region.

The unifying thread in this paper is that economic growth is closely linked to stabilization, understood in a broad sense, and structural adjustment. In fact the latter are prerequisites for a sustainable growth path.

A main message throughout the paper is that the current difficulties, some of them severe in the terms of trade, stock prices and currencies of many countries of the region caused by the Asian crisis should not obscure the results of what has been accomplished to date and, more importantly, the promising perspectives for the region.

Stabilization

Inflation that plagued the Latin American economies in the 1980s has been largely controlled in the 1990s. Fiscal deficits that were at the root of the problem have been corrected. The burden of the external debt, a main detonator of crises of the past decade, has been greatly reduced through a variety of schemes with the Brady agreements being the predominant form. Also the decrease in international interest rates has lightened the stress imposed by foreign debt servicing.

Stabilization required a large dose of fiscal restraint and governments learned to control their fiscal accounts. The Olivera-Tanzi effects in reverse also contributed to improve the fiscal position. Fiscal deficits have remained low in most countries of the region during the 1990s. Some countries, like Chile, have permanently exhibited fiscal surpluses. Deficits of the order of 4-5%, considered manageable a few years ago, are no longer tolerated at the present time.

Events that seemed highly unlikely at the end of the past decade came to pass a few years later. The most important was, undoubtedly, the renewal of capital flows to Latin American countries via several distinct forms: foreign direct investment, portfolio equity and other long-term flows, and short-term capital.

The inflow of capital contributed to the efforts of many countries in the region to stabilize the prices of goods and services. Although the outcomes depended on initial conditions, it is fair to say that loosening the foreign exchange constraint stabilized the foreign exchange market and, in many cases, inflation.

Inflation and fiscal deficits have been largely controlled but new threats to macroeconomic stability have emerged, sometimes with catastrophic effects although of short duration. Macroeconomic stability these days cannot be considered without a sustainable current account in the balance of payments and a safe and sound financial system.

The definition of a sustainable current account in this era of abundant but volatile capital flows is a subject of debate; so are the instruments to attain it once a definition is agreed upon. My personal preference is for the traditional definition related to the financing of the deficit by long-term capital flows. If foreign saving via foreign direct investment and long-term credits (even better if they are concessional) is financing productive investment, it should be welcomed. Economic history teaches us that the contribution of foreign saving to the development of many countries has been crucial. We cannot imagine, for instance, the development of the United States in the 19th century without the accompanying massive flow of foreign capital, particularly from the United Kingdom.

The prevailing vision in international financial institutions is very much marked by the Asian crisis (and perhaps by the Mexican crisis). In my reading, financing of the current account deficit, and particularly liquidity problems caused by short-term capital flows, induced the larger and more severe problem of exchange rates in free fall. If a current account deficit is largely due to an expansion in consumption or in non-productive investments, financed moreover with increasingly shorter-term capital, there is indeed a high likelihood of disaster. Political or other exogenous shocks

can trigger a major financial crisis, as happened in Mexico at the end of 1994.

To summarize, it is not the current account deficit per se at the root of the problem but: 1) whether the source of the deficit is an expansion of demand resulting from consumption and investment of doubtful long-term profitability or productive investment, and 2) the nature and maturity of the capital financing the deficit. Short-term and volatile flows are of course dangerous. The dynamics of the maturity of the capital inflows are also important. As doubts emerge on the sustainability of the deficit, maturity decreases and the interest costs increase. However, if investments increase capacity in the tradeable sectors, the likelihood of a current account crisis, followed by an exchange rate crisis, is reduced.

A superficial reading of the numbers on the current account deficit by financial markets, ignoring its fundamental causes, may be dangerous and lead to acute liquidity problems. Despite our plea for a subdued approach to the problem, one needs to be aware of the dangers of a high current account deficit, regardless of the source.

The slow growth of exports and their concentration in few commodities are probably more worrisome than the current account deficit. The demand for exports of course depends on world income and, at least for the manufacturing sector, on the real exchange rate. The most important effect of the Asian crisis in Latin America to date has been on the export prices of commodities. The effect moreover could last several years. Latin American manufactured goods may face strong competition from Asian countries with very depreciated currencies, in the region's markets as well as in world markets.

If foreign savings substitute domestic saving, little will have been gained for investment and growth. Of course, the rate of domestic saving in Latin America needs to increase. This is an issue related but not coincidental with the current account problem.

The literature regarding stabilization in inflation-prone countries doesn't emphasize interest rates sufficiently, as it is rightfully concerned with

quantitative targets and exchange rates. In exchange rate-based models of stabilization, interest rates are significantly more important than in the money-based stabilization models. Still, in both cases their role is very instrumental. As a legacy of the stabilization process real interest rates in many countries of the region remained substantially above world real interest rates. Unbent inflationary expectations were considered a mayor culprit, especially if inflation stabilization was achieved by a strong initial tightening of the money supply. Two additional explanations, more microeconomic in nature, are given. The first one refers to the risk premium assigned by domestic and foreign investors alike to invest in countries that had just recently experienced a igh degree of macroeconomic instability. This may explain a short-run phenomenon - the explanation is more difficult to hold over a long period. The second one is related to the workings of the financial sector, particularly the banking sector. Banks tended to follow a strategy that combined high borrowing rates to attract deposits with high lending rates to maintain profitability. They indulged in this strategy because they could shift the risk to the central bank, given its implicit guarantee to depositors and other privileged creditors.

The fact is that in the early 1990s countries of recent stabilization remained with very high nominal and real interest rates. In a world context of high liquidity this was an invitation for capital flows to the countries in the region labelled by the financial press as “emerging markets”. Moreover, in addition to taming inflation the emerging economies had undertaken very significant structural reforms, particularly privatization, that was music to the ears of foreign investors. Thus beginning around 1991-1992 many countries in the region began experiencing voluminous capital inflows, many of them through portfolio equity and bank deposits. The tide of capital was so overwhelming that the initial distinction between countries with “good” economic policies and countries that had not yet stabilized soon disappeared.

This rapid inflow of capital created new problems that have been fairly well studied, among them real exchange rate appreciation and inflation of asset prices. The latter effect was particularly pernicious as this frequently translated into “bubbles” in the real estate and stock markets. The former significantly contributed to the difficulties of the current account of some countries of the region. In hindsight, it seems that in these private capital movements there was also an underestimation of risks.

The measures taken to limit the negative impacts of the inflows, such as sterilization via open market operations by the central bank, have been frequently self-defeating with offset coefficients close to unity. Open market operations raised interest rates which in turn encouraged more capital inflows. While quantitative restrictions on the inflows, such as minimum reserve requirements, had an impact this may have been small.

This "outside" money gave a big impetus to the banking sector. Deposits and credit granted by banks grew, in real terms, at significantly higher rates than GDP and investment. The credit boom was followed by banking crises that have plagued many countries in the region since 1994. Although very significant progress has been accomplished, the problem of weak banks has not disappeared.

Financial stability, particularly of the banking sector, has now become a policy target and a crucial component of macroeconomic stability. The trouble is that the concept of financial stability itself is more difficult to define than, say, inflation control. The literature insists in the distinction between stability of financial institutions and stability of financial markets. I will limit my comments to the latter. The failure of an individual institution doesn't mean by itself the break down of financial stability. Moreover, the liquidation of insolvent banks (as in any other business) may be justified on efficiency grounds and may well be a market solution. Yet, to what extent do individual bank failures not pose a threat to macroeconomic stability? There is indeed always a danger to it. Contagion effects create risks for the whole system.

Financial and macroeconomic stability are closely related. Financial stability is essential for the efficient channeling of savings to the best investments and ultimately for economic growth.

Banking crises can be very destabilizing. The examples of Venezuela and Mexico in 1994-1995 and Asia currently are highly illustrative. My country, Bolivia, also suffered a mild crisis in 1995. Paraguay now faces a crisis of magnitude.

While unsustainable interest and exchange rate policies may trigger a banking crisis, most experiences show that excessive risk taking, mismanagement and fraud within the banks are the main causes. Hence the standard advice to reinforce regulation and supervision. This is, of course, easier said than done. In particular, management problems vary across banks. Also, the political economy of regulation, supervision and resolution is becoming very complicated, as is shown for instance by the Mexican case.

Adjustment

Along with programs to control inflation came the structural adjustment programs to increase efficiency and to facilitate the re-insertion of the economies in the world economy. Adjustment programs involved the liberalization of the goods and factors markets, with varying intensities and scope. The pace and sequencing of the liberalization measures were hotly debated among academics but practitioners preferred, in most cases, a rapid and simultaneous approach to all markets.

The elimination of quantitative restrictions and the lowering and uniformity of import tariffs were among the first measures taken. While the elimination of quantitative restrictions was indeed significant, the lowering of tariffs often amounted only to removing the "water" or redundancy in the tariffs. Tariffs have remained high vis-à-vis the prevailing tariffs in the industrial countries (but in the latter countries quantitative restrictions abound). After the unilateral reduction of tariffs, further liberalization was pursued on a regional basis, with free trade zones and agreements of economic complementation. These arrangements, that are still of limited scope, have yielded to date some significant results and promise to further increase trade and growth.

Along with the liberalization of foreign trade, actions were taken to liberate the domestic markets for goods and to align domestic prices with international references, even in the case of some non-tradable public services. These measures greatly augmented the available supply of goods. Unfortunately some segments of the urban poor suffered from the lifting of price controls and subsidies. Compensation schemes like social emergency funds were often insufficient or mismanaged.

The liberalization of financial markets was also of great scope and met very little resistance. The liberalization included *inter alia* the elimination of interest rate ceilings and floors, the dismantling of regulations that allocated credit sectorially, and the privatization of state-owned banks. In some countries, like mine, financial liberalization also permitted both transactions in dollars among residents and dollar-denominated deposits in the domestic financial system.

The independence of central banks was another institutional development with far reaching consequences. Independence has largely implied : a) the lifting of political pressures on the governing boards of central banks; b) very tight limits on lending, directly or indirectly, to government; and, c) more precise definitions of permitted monetary operations and of the relationships with the private financial sector. Also, independence has been accompanied by more transparency of central banks.

The liberalization of rural land markets has varied across countries. It was significant in Peru and Mexico; it was nil in Bolivia. A similar comment can be made vis-à-vis the deregulation of the labor market. By and large, labor flexibilization is yet to be achieved.

Privatization, together with flexibilization of the labor market, are probably the most far reaching reforms. All countries in the region with a significant public sector have gone into a spate of privatizations. The case of Bolivia, that had the largest state-owned sector in Latin America with the exception of Cuba, is illustrative. After some hesitation that lasted until around 1995, very little now remains in the hands of the public sector. Mining, hydrocarbons, telecommunications, banking, transport, manufacturing, electricity, water and road construction are now in the private sector. Also, the social security system is now private, with a fully funded system that replaced the previous "pay as you go" scheme. The surprising thing is that this has been achieved with relatively little political opposition.

Privatization, especially of natural monopolies, requires a whole new set of institutions. Governments in the region have become governments of regulators, isolated in principle from the political process and for whom there are still unresolved issues of accountability. A better definition of the roles and responsibilities of the regulators is still a pending agenda.

The most difficult reform to date has been the flexibilization of labor legislation. In many countries labor laws, dating back to the 1930s and 1940s, are very protective to those employed in the formal sectors of the economy but hinder the creation of new jobs. In most instances the problem with labor laws does not lie entirely in the known costs for employers and employees, even if lowering them would increase employment, but in the hidden costs and especially the legal contingencies they give rise to. It is the case that dismissed workers, even after having been properly compensated with generous severance payments, still sue their former employers with new and twisted interpretations of the labor legislation. Special labor courts have been particularly notorious for being sympathetic to these interpretations.

A thorough revision of the labor laws is in order. The lack of labor mobility impedes a proper allocation of resources. Reasonable protection to workers and their incomes needs to be maintained; still, market forces could lead in most cases to the design of proper institutions and contracts that protect workers without the support of special legislation.

Development

Stabilization and adjustment are not of course ends in themselves but rather necessary conditions for sustained growth and development. Development has a broader meaning than growth, in the sense that it includes wealth and income redistribution issues.

The main problem is how to increase the long-run rate of growth of the economies. Theoretical and empirical studies show that the long-run rate will increase with gains in labor productivity and, more generally, with gains in total factor productivity.

The enhancement of labor productivity requires in all likelihood the implementation of deep education reforms, which is not an easy task. Moreover, the results of education reform will come about only after several years if not decades. In the poorer countries of the region the focus is rightly on directing resources to primary education, yet higher education cannot be

ignored although selectiveness in public expenditure is required with the beneficiaries sharing the expenditures.

A main objective of the structural reforms is to increase total factor productivity. A well functioning price system, contingent itself on macroeconomic stability, should lead to the best allocation of resources. Sound financial institutions are also a condition for growth. Labor market flexibilization is of extreme importance to increase the growth rate of the economy and to ameliorate employment.

Technical progress is frequently embodied in capital goods, especially at the current stage of development in Latin America. Hence the old recipe of high investment rates, intensive in imported capital goods, remains valid. This is especially true for countries whose development is based on the exploitation of large natural resource endowments.

With the high degree of openness in Latin American economies the evolution of world income, especially of the industrial nations, is of extreme importance for the path of the region's income. The benefits of openness have a better probability to materialize if income in the industrial countries grows steadily. Of course, the free trade zones will also give a plus to growth.

Unfortunately, the current Asian crisis and its probable consequences on the large industrial economies pose a real threat to the economies in the region. However, most economies seem more resistent to adverse shocks than in the recent past. The robustness comes from sound macroeconomic policies and structural reforms. Market corrections, in some cases overdue, of stock prices and currencies should not in this context have lasting negative effects.

Political stability is also an ingredient to attaining a higher long-run rate of growth. Political uncertainty increases the subjective probability of reversal of the rules and reforms and *de facto* operates like a tax on investment producing heavy deadweight losses. Long run political stability in turn will depend very much on a better distribution of income and wealth than that currently prevailing in most countries of the region. The resulting displeasure with the state of affairs leads to more acute political

confrontations than otherwise. Excessive politization resulting from redistributive issues impinges upon the quality of economic decisions. Also poverty and asymmetric income distribution provide a fertile ground for the populist policies that have so greatly damaged Latin American countries in the past.

Corruption in a mostly deregulated economy adds very significant costs to investment and produces a misallocation of resources, in addition to fiscal damages that give rise to moral wounds and to the erosion of the public's confidence in the institutions and their leaders. Corruption itself and the public's sentiment that corruption is pervasive can be highly detrimental to growth. I suppose that it would be possible to model a multiple equilibrium growth model in which the economy gets stuck in a low equilibrium rate of growth because expectations are highly influenced by the fear of corrupt practices.

GDP growth is not, of course, the only component of welfare. Other measures have to be included, such as the ones that appear in the human development index published by the United Nations. Increases in welfare measures will depend very much on the quantity and quality of public expenditure in the social sectors of health, education, water and sanitation. There is significant experimentation going on regarding the best ways to deliver these services, without conclusive results yet. A common experiment is decentralization in the provision of services to local governments. It is too early to evaluate the benefits of this policy.

Concluding remarks

The prospects for Latin American economies notwithstanding the present effects of the Asian crisis seem reasonably good. Structural reforms grafted onto macroeconomic stability can indeed be conducive to a sustainable high rate of growth of output. However, attention beyond that of a convenient political promise needs to be redirected to equity problems and poverty alleviation.

The main danger in this generally favorable scenario comes from external shocks. But even in this case, what has been obtained in terms of

macroeconomic stability and the advances in the structural reforms should give the needed resilience.

It is important not to lose perspective. All economies are subjected to exogenous and in many cases random shocks. The problem is thus how not to aggravate the adversities with shortsighted policy measures that may provide immediate relief but incur longer-term side effects.

Lastly, more research and understanding is needed on the consequences of the structural adjustments on long-term growth and income distribution.