

Macroeconomic Overview of the Andean Countries: Economic Scenarios for 1999

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It is difficult to speak of the experiences of the Andean countries (Venezuela, Colombia, Ecuador, Peru and Bolivia) as a whole since they exhibit significant differences with regard to their development, especially of their financial markets. Similarly, the policy responses to the current economic crisis have also varied. We will, however, attempt to make some broad generalizations.

Some of the external shocks to the region have been common, for instance to the terms-of-trade. On the other hand, the financial shocks have been more idiosyncratic at least in the ways they appeared.

The most important effect of the international crisis in the region to date has been on the export prices of commodities. In the five countries of the Andean Community commodity exports weigh heavily on total exports, in spite of their declining share in total exports. Since the third quarter of 1997 the prices of gold, copper and zinc have fallen precipitously. Somewhat later the prices of silver, coffee and cereals like soybeans also fell. The price of oil fell precipitously during 1997 and 1998 but started a strong recovery in the second quarter of 1999. Also, the Andean manufactures face the strong competition of Asian exports with very depreciated currencies, in the region's markets as well as in world markets.

The Brazilian devaluation of January 1999 shocked the economies of the region, albeit to a lesser extent than was feared. Exports from the region to Brazil are modest and therefore do not suffer much. However, some exports to third countries now have to compete with cheaper Brazilian exports. Even more important, the domestic industries face the strong competition of cheap imports from Brazil, some of which are smuggled goods.

However, non-competitive imports are also being bought at lower prices that partially compensate for the decrease in export prices. Hence, the fall in the terms-of-trade is lower than the one in export prices. A more subdued picture is obtained if the analysis takes into account the changes in the terms-of-trade and not exclusively on exports, as is frequently made.

The Brazilian devaluation had an impact on the financial markets of the region. Although the impact was short lived, as a consequence of the cascade of crisis (Asia, Russia and Brazil) the credit conditions for the Andean countries have become harsher. All Andean countries devalued their currencies, sometimes with a lag and in small steps after the Brazilian devaluation.

The fall in export prices has had negative consequences not only on the current account of the balance of payments, to which we refer below, but in Venezuela and Ecuador, and to lesser extent in Colombia, on government income, creating de-stabilizing stresses to the fiscal budgets.

Two countries in the region, Ecuador and Peru, suffered two exogenous shocks of magnitude in 1998: one on export prices and the other from the effects of El Niño, which led to severe flooding. Bolivia, as a consequence of El Niño, has had drier weather than normal, which has led to smaller crops in staples and export agricultural products.

In all countries of the region the rate of currency depreciation started increasing around the fourth quarter of 1997, independent of the countries' exchange rate regime (wide bands, with a positive slope, in Venezuela, Colombia and Ecuador, and floating exchange rates in Peru and Bolivia). Wide bands and, obviously, floating exchange rates gave some flexibility to the macroeconomic management of the current account crisis. However, exchange rate management seems to have been more affected by movements in the capital account than by current account shocks.

In the case of bands, some of the response was absorbed by the exchange rate and the other part by increases in interest rates and public expenditure cuts. In Peru, high interest rates have been a feature since the inception of the stabilization program in 1990 and no further increases were brought with the crisis. In Bolivia, the floating exchange rate regime is very heavily administered, and is close to a crawling peg. In addition, its economy is very dollarized; hence the room to maneuver the exchange rate is very limited. No significant changes in interest rates have taken place and public expenditure cuts have not been very significant to date.

Once the Asian crisis developed, the fall in the terms-of-trade further enlarged the already large current account deficits in the balance of payments in all the countries of the region. Right before the Asian crisis the relatively large deficits in the current account were due in part, but only in part, to overly expansionary domestic policies, and to the surge in foreign direct investment, which in most cases implied substantial imports of capital goods. Thus, in the latter case, the deficit was caused by the availability of this form of investment finance rather than by a fall in savings.

With some difficulties, the Andean countries seemed to be weathering the terms-of-trade shock up to the first semester of 1998. In the wake of the

widening of the current account crisis caused by the lower commodity prices, some nervousness in the financial sectors of the Andean countries emerged, but this did not evolve into a panic until the Russian devaluation and debt moratorium.

The countries that were the most advanced in their structural reforms appeared to better withstand the negative effects of the Asian crisis. We should not forget that the economies in the region, with some exceptions, were stable. Colombia had a 50 year track record of stability. Inflation, which plagued many economies in the region in the 1980s, was in the 1990s largely controlled. The burden of the external debt, a main detonator of the crisis of the past decade, has been greatly reduced through a variety of schemes, with the Brady arrangement being the predominant form.

Fiscal deficits that were at the root of the inflation process were corrected. Stabilization did indeed require a large dose of fiscal restraint and governments learned to control their fiscal accounts. Fiscal deficits have remained low in most countries of the region during the 1990s. Venezuela and Peru built surpluses in 1996 and 1997. Deficits on the order of 4-5%, considered manageable a few years ago, were no longer tolerated.

Despite the over all progress in the region, full stabilization remained elusive for Venezuela and Ecuador in the mid-nineties. Venezuela's problems were prompted by its banking sector crisis while Ecuador suffered from political instability, a weak banking system, the expenses of the war with Peru, and more recently, supply shocks brought about by El Niño. There was a strong recovery of the Venezuelan economy in 1997 but the results for 1998 and, especially, the first months of 1999 have been dismal. In the final months of 1998 Ecuador adopted a very forceful stabilization program that included the courageous dismantling of subsidies. In addition, the peace with Peru greatly improved its prospects. Yet, the weakness of its financial sector and the lack of a political agreement on tax measures to redress the fiscal budget impede the reaping of peace dividends and the benefits of the 1998 reforms.

Along with the programs to control inflation came the structural adjustment programs to increase efficiency and to facilitate the re-insertion of the economies into the world economy. 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. Also, the social security system is now by-and-large private, with a fully funded system that replaced the previous pay-as-you-go scheme.

In the early 1990s, the countries that stabilized did so at the cost of very high nominal and real interest rates. In a world context of high liquidity this was an invitation for capital flows to the region. Moreover, in addition to taming inflation the emerging economies had undertaken very significant structural reforms, particularly privatization. These events led to the renewal of capital flows to the countries in the region, under several modalities: foreign direct investment, short-term portfolio equity and other long-term flows, and short-term capital. The countries in the region have significantly opened the capital accounts of their balance-of-payments, with Peru and Bolivia maintaining a full open account, with no restrictions. The flows that started around 1991, with a lapse after the Mexican crisis, indeed had beneficial effects but also carried some dangers. More capital meant more investment. Also, it 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 helped to stabilize the nominal exchange rate and, in many cases, inflation.

A point to underscore is that the countries in the region built considerable international net foreign exchange reserves, either from current account surpluses like Venezuela in 1996–1997, or from capital flows. The high level of reserves dampened some of the effects of the Asian crisis, at least until the first semester of 1998.

However, the rapid inflow of capital created new problems. Among them: real exchange rate appreciation and inflation of asset prices. The latter effect was particularly pernicious because it often took the form of “bubbles” in the real estate and stock markets. The former significantly contributed to the current account difficulties of some countries in the region through an increase in private expenditure generated by the wealth effect.

The “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. Banking crises that have plagued some countries in the region since 1994 followed the credit boom. Although very significant progress has been made, the problem of weak banks has not completely disappeared.

In the views of the authorities of all countries of the region, financial stability -particularly of the banking sector- has become a policy target and a crucial component of macroeconomic stability.

With weakened economies (but very far from distressed economies) resulting from the scope of the reform efforts, the countries of the region had to face the effects of the Russian catastrophe and the crisis of confidence spanned by fears that Brazil would devalue. After the Russian crisis countries with stock markets of significant size suffered considerable losses. They had been experiencing losses since the end of 1997 but not as severe. Portfolio capital flows stopped or were even reversed, and foreign borrowing became significantly more difficult. The spreads over US Treasury bonds reached 2.000 basis points or more for sovereign debt issues. Attacks against the currencies of three countries in the region stepped up, forcing the governments to defend them with steep increases in interest rates. Ultimately, Colombia and Ecuador had to devalue.

Lower commodity prices and capital inflows obliged the countries to review their forecasts of output growth for 1998 and, in some cases, their rates of inflation.

The prospects of growth in the Andean countries hinge on the maintenance of growth in the industrial countries. They also depend on the continuation of foreign credits (at a minimum to finance trade operations but hopefully also operating capital and investment), on strengthening the confidence of domestic financial markets, and the continued momentum of structural reforms. The choice of an exchange rate regime should not be a major issue, except if the need arises to better coordinate macroeconomic policies among the countries of the Andean Community.

If world income grows at the rate of the major industrial countries, there is some hope for an increase in the demand for commodities and therefore a reversal in their current price trends. Also, with more favorable real exchange rates, exports of manufactures within and outside the region could pick up momentum. A weakening of the dollar should also add momentum to the exports of manufactures to industrial countries other than the United States.

It is too early to conclude on the duration of the slump in export prices. Should it be perceived as transitory, the increase in the current account deficit, caused by the fall in the terms-of-trade, must be financed by lines like the Compensatory and Contingency Financing Facility of the IMF. If the perception is of a long-lasting price bust, structural adjustments that take time to be implemented will be needed.

The stability and growth of the region could be greatly threatened by strong credit rationing. The recent world events seem to indicate a low probability of this happening. Yet, international credit to the best enterprises and banks in the region has become scarcer. Large firms that normally would find financing with international banks have had to resort to domestic banks, a move which crowds-out medium and small-scale enterprises from credit. Banks, with lower access to international lines, are starting to feel liquidity problems. Firms and banks alike have to face harsher credit conditions.

The largest and best banks of the region have granted significant credits to the export sectors in the Andean countries. The difficulties of these sectors and, more generally, the slowdown in growth have translated into a deterioration of the quality of the loan portfolio. This, coupled with a more difficult access to international sources of finance has created some stress in the banking systems of all the countries in the region.

In the countries that have strengthened regulation and supervision of their banks, the likelihood of a major banking crisis is small. But even so, the persistence of liquidity problems may create a confidence crisis. This may further erode liquidity. Part of the problem may be solved, paradoxically, by a slight and temporary relaxation of the regulations on the banking system, based on the Basel Accords. Regulation and supervision are designed to preclude excessive risk taking and mismanagement in the banks, but they may have costs in terms of liquidity for the system in the present juncture.

The international financial institutions may help to strengthen confidence in the domestic financial sectors by granting contingency lines of credit, similar in design to the repo facility granted by commercial banks to Argentina.

Given the fact that all the countries in the region have become importers of capital, the effects of lower capital inflows will not be independent of the form that previous capital inflows took. Unless the fall in commodity prices is protracted or there are doubts on the macroeconomic and political stability of the host countries, foreign direct investment should continue or even increase to take advantage of the lower asset prices after the crisis. If this happens there will of course be a deficit in the current account, which needs to be sustainable.

The definition of a sustainable current account in this era of volatile capital flows is a subject of debate, as 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 under the form of foreign direct investment and long-term credits (even better if they are concessional) is financing productive investment it should not be shunned.

It is not the current account deficit per se which is the problem but: 1) whether the source of the deficit is an expansion of demand spanned by consumption and investment of doubtful long-term profitability or by 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 costs of interest increase. However, if investments increase capacity in the tradable sectors the likelihood of a current account crisis, followed by an exchange rate crisis, is reduced. Should foreign direct investment cease or be substantially less than expected, the countries of the region will have to undergo painful current account adjustments. This will imply reductions in expenditure and likely a recession.

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 international crisis, should not obscure the results of what has been accomplished to date and, more important, the perspectives for the region. The long-term prospects for the Andean economies seem reasonably good. The structural reforms grafted onto macroeconomic stability can indeed be conducive to a sustainable high rate of growth output. What has been obtained in terms of macroeconomic stability and the advances in the structural reforms should give the needed resilience to withstand the current crisis.

It is important not to lose perspective. All economies are subjected to exogenous, 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 with longer-term side effects.