LATIN AMERICA: SUSTAINING ECONOMIC AND POLITICAL REFORM

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Overview

Most countries in Latin America and the Caribbean were able to weather the economic crises of the late 1990s better than expected, thanks to the policy reforms of the past two decades.

Further reform is urgently needed, however, to put the region on a faster growth path and reduce its vulnerability to external shocks.

The pre-conditions for economic and social reform in Latin America proved to be more complex than it was foreseen some years ago.

There is a growing concern about governance within Latin America. The evolving conventional wisdom on economic policy is that a weak governance may put in jeopardy the painfully established economic reforms within the region; and the process of economic change could well dry out.

These concerns are realistic. Social inequality prevails and events within the political sphere do not look promising: the democratization current is weakening and the future could bring further instability. The twin principles of free-market and democracy could meet severe implementation obstacles in Latin America.

The reforms of the 1980s and 1990s

As you know, after the economic failure of the eighties, named as the lost decade, a new consensus was built around the need for undertaking economic reforms and preserving macroeconomic equilibrium as a way to maintain sustained growth and development.

This new paradigm was especially promoted by international financial organizations like the World Bank ant the International Monetary Fund. The basis of this new paradigm was the search for macroeconomic stability through a mix of monetary and fiscal policies and structural reforms that contribute to keeping inflation under control and the performance of the economy up to its potential.

Most countries in the region undertook bold and wide-ranging structural reforms aimed at dismantling price controls and removing existing market distortions, with an emphasis on trade reform, financial liberalization, and the privatization of public enterprises.

- *Trade reforms,* extensive and widespread, included sharp reductions in tariffs and in their dispersion (average tariffs fell from nearly 45 percent in 1986 to 14 percent in 1998, and maximum rates declined from an average of 80 percent to about 30 percent) and the dismantling of most quantitative and other nontariff trade restrictions. Regional trade agreements surged.

- *Financial liberalization* was carried out on both the domestic and the external fronts. Direct credit controls were abandoned and interest rates were deregulated and allowed to reach real positive levels. Foreign investment regimes were liberalized, and most controls on foreign exchange and capital transactions were dismantled. After the Mexican crisis of 1994, steps were taken to strengthen banking regulation and supervision and establish more demanding prudential standards.

- *Privatization* had several aims: eliminating the operational losses that plagued many state-owned enterprises, improving overall efficiency, and increasing private investment. Nearly 800 enterprises were privatized between 1988 and 1997, most of them in the utilities sector, which had traditionally been closed to private sector participation and which was perceived as having the greatest potential for productivity and efficiency gains.

Economic results

Throughout the nineties, the reforms developed had an impressive impact on allowing stagnant economies to attain high rates of growth in a number of cases. Chile, and its outstanding performance during the nineties, was frequently used as the materialization of this paradigm.

The region's average fiscal deficit shrank to about 2 percent of GDP in the mid-1990s, from 4-5 percent in the late 1980s. Countries achieved a more balanced tax burden, with lower trade taxes, increased tax efficiency, and higher ratios of tax revenues to GDP. The ratio of external public debt to GDP fell to less than 20 percent in 1997, from about 50 percent in the late 1980s.

The improved fiscal stance made it possible for countries to achieve a more disciplined monetary management and to reduce central bank credit to government. The authorities increased their use of indirect instruments of monetary policy, with a view to enhancing the role of interest rates and improving the efficiency of monetary management. Many also strengthened economic institutions and increased the independence and accountability of their central banks, which were given the explicit mandate of pursuing price stability.

Remaining weaknesses

In Chile, after almost 15 years of uninterrupted growth and a crisis of external origin that sent the economy into a recession, we have more elements of judgement at hand to reflect about the challenges we face in conducting the economy toward a broader and more equal development.

The recent crisis left in evidence, that macroeconomic equilibrium, as well as structural reforms do not eliminate economic cycles, along with episodes of higher rates of unemployment. That is to say, the market economy has been effective in rewarding the success of those "winners" of our society, but in some cases is cruel to the "losers".

Even though during the 90's there was significant progress in poverty reduction, mainly as result of social policies undertaken throughout that period, improvement in the distribution of income was less marked. As a consequence, the evidence shows that there is a growing feeling of social vulnerability or insecurity in different aspects of our society.

Although Latin America and the Caribbean coped better with the recent financial turmoil than expected, the recurrence of external shocks and country-specific crises demonstrate that weaknesses remain and that further reforms are needed.

- **External vulnerability.** Given the sharp rise in the number and volume of cross-country financial transactions and the growing integration of financial markets, the size and volatility of international capital flows have increased. Crises have unfolded more quickly and less predictably and spread faster from one economy to another. The region's dependence on foreign financing has led at times to an unsustainable build-up in domestic demand, a widening of the external current account deficit, and large fluctuations in the real exchange rate. The economies of Latin America and the Caribbean have also remained vulnerable to fluctuations in export prices because, with a large endowment in natural resources, exports tend to be concentrated in commodities or semi-commodities. In the 1990s, export receipts grew more slowly than both export and import volumes.

- The region's growing integration in the world economy was not accompanied by the development of matching macroeconomic policy instruments. The scope for countercyclical policies was often limited by inconsistencies between fiscal and exchange rate policies and, as discussed below, by the fragility of the fiscal position, reflected in low levels of national savings. Thus, efforts to maintain macroeconomic stability relied mostly on a significant and often prolonged tightening of monetary conditions.

- **Fiscal fragility.** The recent crises highlighted the importance of prudent fiscal policy for financial stability. Increases in public savings, although partly offset by declines in private savings, have been shown to boost national savings. Further, sound fiscal management can improve overall economic efficiency, because it frees scarce financial resources that can be dedicated to productive, income-generating investment.

- Although the Latin American and Caribbean countries have taken steps to strengthen their public finances, by the end of the 1990s there was a resurgence of fiscal deficits that was due in part to the economic downturn and in part to problems that have not yet been addressed.

- ***Weak institutions.*** Although countries throughout Latin America and the Caribbean embraced democracy during the 1990s, efforts to improve the quality of public institutions and services have often lagged behind other reforms. Legal and regulatory procedures, while improved, remain cumbersome. The protection of contractual and property rights is largely inadequate, and many business transactions are still informal. Institutions, including the courts, are weak and discredited in many countries and barely function in some. The quality of public services is often poor, corruption is widespread, and crime and violence have increased.

- Corporate governance is also generally inadequate. Despite advances in banking regulation and supervision, banking sectors in many countries remain fragile, with low capital bases and high intermediation costs, and regulatory enforcement remains weak.

The Need for a New Perspective

Thus, we may say that the market by itself is not enough for resolving the problems that affect a developing country. The role of the state in this area acquires an inescapable, though not exclusive, ethical content. The challenge therefore is evident: to advance in this field without putting at risk economic growth and macroeconomic equilibrium.

Our government's answer to this situation has been extensive and considers substantial changes in the institutional framework, such as the educational reform, the judicial reform and the design of a new unemployment insurance scheme. However, the action of the State turns out to be incomplete in the best of cases, if it does not count with the contribution of the parties involved.

The bases of a sustainable economy and society are not exclusive tasks of the State. Respect for the dignity of people, the community and our environment, are indispensable conditions for sustainable development. The initiatives in this sense accelerate the transit toward a more developed society.

Economic policies

To seize the opportunities offered by integration into the world economy, Latin America and the Caribbean must develop a policy framework that will reduce its vulnerability in the face of downswings in international trade and finance. This hinges, in turn, on two crucial elements: fiscal consolidation and better governance.

Fiscal consolidation would help reduce Latin America and the Caribbean's external vulnerability, because it would allow for more proactive fiscal management and boost national savings. Prudent monetary management, sound exchange rate policies that prevent severe currency misalignments, and adequate prudential regulation for the banking and financial systems also play a key role.

Governance is as crucial as it is complex and multifaceted, because it permeates nearly all aspects of economic performance.

The formal adoption of appropriate policies is useless if a country's institutions do not have the capacity and the incentives to ensure that policies will be adequately implemented. In turn, the characteristics of the environment in which citizens interact with each other and with government agencies, is a relevant factor underlying these variations. Hence, getting the policies right may not, by itself, be sufficient for successful development.

Good governance is marked by predictable, open, and enlightened policy making (that is, transparent process); a bureaucracy imbued with a professional ethos; an executive arm of government accountable for its actions; and a strong civil society participating in public affairs; all behaving under the rule of law.

The Challenges of the New Economy

Another challenge our country faces is the integration of our companies and processes into the so-called "new economy". The new economy is a phenomena that is occurring in the developed world, particularly in the U.S., characterized by huge gains in productivity, driven by the information technology sector, and sectors that are technology intensive.

As some analysts say, these gains in productivity represent a structural change of the economy, which can last for a long period of time. As a consequence, some economic parameters such as the sustainable GDP growth and the natural rate of employment are in a process of upward revision.

The globalization of world economies and businesses is considered a cause and effect of such a technological revolution, through which new and more efficient tools such as the Internet, information and telecommunication development have played a key role in new production processes.

Chile, as well as all Latin America, as an increasingly globalized region, requires the adoption of serious, rapid and flexible policies in order to access this new paradigm. This implies the training and relocation of human and financial resources to an extent that our region currently lacks. In this context, education plays a key role.

In order to take advantage of these opportunities, our economies require mechanisms that allow financing initiatives linked with the new economy, that it is to say, high technology companies, internet services, etc, all of which are characterized by increased uncertainty.

These types of enterprises require venture capital financing, to allow them to create and expand activities in the technology sector, and thus enhance the efficiency and productivity of the economy in the long run. Today, our financial markets are not capable of supporting and financing these activities, especially after the financial crisis that affected our economy over the last two years.

These problems affect Latin America as a whole. For that reason, in order to fully exploit the benefits that the new economy offers, it is necessary to not only adopt internal policies, but also regional alliances among the economies of the Southern Cone. These should tend to globalize and integrate our economies, systems and experiences into technologies associated with internet, the globalization and the knowledge society.

International Trade Agreements

All possible flows have substantially increased within the region: people, means of transportation, communications, goods, and capital are circulating as never before, and the intensification of political exchanges has been truly impressive, setting the foundations of a real process of Latin American integration. The effects of these developments have been felt in the Free trade Area of the Americas (FTAA) negotiations because, more and more, economic integration at the hemispheric level is becoming a necessary framework in order to harmonize the trade policies of the participant countries. This is especially the case of Chile with its many trade agreements.

Clearly, the one country in the hemisphere which has not been able to make much progress in regional trade liberalization since signing the NAFTA, because of its own internal political debates, is the United States. However, conditions have changed substantially in the rest of the hemisphere since trade liberalization in the Americas was first proposed.

In this context, the FTAA negotiations have tested the hemisphere's real committment of advancing towards economic integration. Since their beginning in September 1998, after the Second Summit of the Americas in Santiago, the FTAA negotiations have made great progress and by April 2001, just before the next Hemispheric Summit, a draft of the final agreement will be ready. Even if this text will still have a lot of brackets, much of the work leading toward hemispheric trade liberalization will have been done.

We perceive that, in fact, progress regarding the technical aspects of this crucial negotiation has been more swift, than that in the political sphere.

Originally, the FTAA negotiations were scheduled to be completed by 2005. However, the dynamism and the level of consensus reached during these last 18 months of negotiations make it possible to set a new deadline, and we are proposing that the FTAA-agreement should be completed by the time of the Fourth Summit of the Americas in 2004.

We will make this proposal to the leaders of our hemisphere in Quebec, next year, at the Third Summit, and hope that they will instruct the trade ministers to have a final text ready by late 2003. This acceleration of the original timetable would be a powerful political signal in the direction of a medium and long-term joint economic and political project in the Americas.