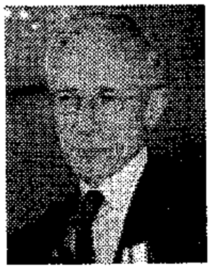

Stanley Fischer

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Latin America 2000

Stanley Fischer
First Deputy Managing Director
International Monetary Fund
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Introduction

It is a pleasure to have been invited to talk today on Latin America, at this fifth LACEA annual conference. The success of the annual LACEA conference is evident from the program and attendance at this event, and I would like to congratulate the founders - among them Guillermo Calvo, Ricardo Hausmann, and Nora Lustig - and the officers of LACEA for their initiative in developing this event, and for the success it has so rapidly become.

It is an extra pleasure that this conference takes place in Rio, at a time when the recovery of the Brazilian economy proceeds apace, and when it is once again possible to look to the longer-term growth of Brazil. It is also a time of marked differences in economic performance among Latin American economies, which implies that the economic situation in the region is even more than usually interesting - and which means that there are many opportunities for interesting applied research work of the type LACEA supports.

Comparative advantage suggests that I should talk about policy issues, and that is the task the organizers assigned me: to discuss policy challenges for the twenty-first century. As the old saying goes, it is difficult to make predictions, especially about the future. So I will focus on the current situation and some of its difficulties, and then discuss the key challenges facing Latin American countries. I will start by describing the global environment, including emerging market trends for Latin America; then turn to economic developments in the region; and finally discuss longer-term economic and political economy issues.

I. The global environment

After the storms of 1994-1999, the current global economic environment for Latin America and other emerging market countries looks unusually calm. There was a period of uncertainty in the spring over the strength of

US growth and the outlook for interest rates, and recent increases in oil prices have caused concerns about the outlook for 2001, but the basic outlook remains favorable.

The US appears to be heading for a soft landing, growth has picked up in Europe, and recovery also seems slowly to be taking hold in Japan. In the WEO, whose forecasts are now over a month old, we expected the world economy to grow 4.7 per cent this year and 4.2 per cent in 2001 - the best performance for more than a decade. Both those forecasts would be shaded down a bit now, especially that for 2001, largely on the basis of higher oil prices, and some signs of a reduction of growth momentum in Europe. Sustained higher oil prices, say prices higher by five dollars than those assumed in the WEO (which were $26 for 2000, declining thereafter), would reduce world growth by about 0.4 percentage points.

World trade is also expected to grow healthily, by 10 per cent this year and almost 8 per cent next year. Continued strong demand from the US - the principal industrialized country trading partner for most Latin American nations - is making an important contribution. Latin America as a whole has gained from recent developments in commodity prices, although the impact varies greatly from country to country, especially as between oil importers and exporters. Copper and wheat prices have risen by about 25 per cent, while coffee and corn prices have fallen. The overall effect has been an improvement in Latin America's terms of trade of around 5 per cent.

Emerging market trends

The signs of a gradual slowing of growth in the US to more sustainable levels, and the associated easing of interest rate jitters, have contributed also to a more benign environment in the capital markets. Latin American bond issuance rebounded strongly after the spring, topping $7bn a month in July and August. The $45bn issued so far this year is well ahead of the $35bn total for 1999. Within this total, a number of small countries, for example Uruguay, have managed to launch successful issues. However, we should note that the increased volume of gross issues includes exchanges of existing debt for new titles at longer maturities and lower spreads, for example by Argentina, Brazil and Mexico, so that net flows have been smaller than gross flows.

Turning to borrowing costs, the EMBI spread for Latin America has resumed a slow downward trend after spiking in the spring. In recent weeks the spread has averaged 600-650 basis points, 10 per cent above the end-1999 level, and 25 per cent above the levels recorded before the Russian crisis (but well into the Asian crisis) in August 1998. Latin American borrowers have benefited not only from the relatively benign external environment, but also from improvements in their own creditworthiness. Of the nine changes to external credit ratings reported so far this year, eight have been upgrades.

Importantly, foreign direct investment has remained strong, as it did throughout the financial crises. But flows into the region are heavily dominated by Brazil.

II. Economic developments in the region

Taken together, the Latin American economies have picked up sharply this year and are doing much better than expected 12 to 18 months ago. Growth has been running at an annual rate of more than 4 per cent, inflation has been roughly stable and in most countries in the single digits, fiscal positions have strengthened, and current account balances have improved. (However, the improvements in Latin American current accounts have been quite modest, even for the best performing countries.) This performance, which marks a sharp change, particularly on inflation, from that of a decade ago, is testimony to the cautious macroeconomic policy management and continued commitment to structural reform in most countries in the region.

However, the regional aggregates mask significant country differences. The average growth rate is pulled up by strong performances in Mexico, Chile and Brazil. The WEO forecast shows growth in Mexico slowing from 6.5 per cent this year to 4.8 per cent in 2001; for Chile growth was expected to rise from 6 percent in 2000 to 6.8 per cent in 2001; in Brazil growth was expected to rise from 4 percent this year to 4.5 per cent next year. These numbers may now be a bit optimistic on Chile. But a number of large countries - notably Argentina, Colombia and Venezuela - as well as some smaller ones, show much weaker growth. Growth in Argentina is forecast at below 2 per cent this year, rising to around 3½ per cent in 2001.

What causes these differences in growth performance? Mexico's strong performance is based on the consistent policies followed since the 1994-95 crisis, and the remarkable strength of its principle export market, the United States, as well as higher oil prices. Those of Brazil and Chile both reflect good economic policies pursued by countries that were hit hard by the global economic crisis only two years ago.

Argentina was affected by the global crisis, by the Brazilian devaluation, and by its lack of degrees of freedom to pursue countercyclical macroeconomic policies - a result on the fiscal side of failing to reduce the deficit enough in good times to be able to increase it in a recession, and on the monetary side by the convertibility regime, which requires the real exchange rate adjustment to come through domestic deflation. The strengthening of the banking system since the tequila crisis has helped the economy withstand the current crisis. Colombia's problems have been worsened by civil strife, but it is pursuing its IMF-supported stabilization and reform program with determination, and despite the difficult circumstances, which have set back the privatization program, growth prospects for next year have been improving. Venezuela is benefiting from the high price of oil, but both macroeconomic and structural policies need significant strengthening.

In short, differences in policies - in some cases policies that have been pursued over many years, differences in economic structures, differences in political conditions that both affect and reflect economic policies and structures, and differences in the impact of external conditions on the domestic economy, are responsible for the wide range of economic performance among Latin American economies.

Differences in the pace of recovery have been mirrored by differences in the cost of obtaining foreign finance. Since the end of last year spreads have narrowed from 363 basis points to 338 in Mexico; they widened from 636 to 701 basis points in Brazil; and from 533 to 691 in Argentina (these are data from October 10.)

The main external risks are that the price of oil could go higher, that United States and global growth could slow, and that the external financial environment would worsen.

Although higher oil prices would have a net positive effect on the region, many countries would be negatively affected by the higher cost of imports, and most would be negatively affected by the decline in world growth that would be likely if there were a significant rise in energy prices. Higher oil prices could also have a potentially negative impact if the income gains they generate in oil-exporting countries weaken commitments to policy reform. The unexpected rise in oil prices has also fueled demands for trade protection and specific assistance programs in some countries. And government control over energy prices in several countries means that higher oil prices translate into a fiscal problem that is politically difficult to deal with - which makes the case for introducing automatic links between domestic and world prices of energy products.

A soft landing of the United States economy, a slowing of growth closer to its potential level, which now looks likely, would result in a somewhat slower growth of exports to the United States from the region. The aggregate effect would depend on whether European and Japanese growth would rise to compensate for the slowing of United States growth.

At the same time, a slowing of United States growth would likely be accompanied by some weakening of the dollar, and probably some strengthening of the Euro. Such an exchange rate change would help Argentina. Provided the dollar declined slowly, United States interest rates would probably not rise, and could even fall as growth falls back towards potential. That is, a soft landing for the United States economy would be mostly good news for several Latin American economies. A hard landing would not be good news, but that seems increasingly unlikely.

I would like briefly to comment further on Argentina, Ecuador, and Brazil. Argentina's economy has been adjusting to the serious external shocks that have affected it in recent years through a decline in domestic costs and nontradable goods prices, as well as in domestic demand. This is a politically difficult adjustment process, but one that has widespread support within the country. With an improved competitive position, a current account deficit under 3½ percent of GDP, the public sector deficit on a declining path and important structural reforms enacted or under way, Argentina is in a good position to resume moderate growth over the short to medium term. To realize this potential the authorities need to maintain fiscal discipline at all levels of government. But it is also time to accelerate supply-side pro-growth structural reforms, including trade liberalization (at the turn of the twentieth century, Argentina was both one of the richest countries in the world and one of the most open; as it closed up, it became relatively poorer - and that process can be reversed) deregulation of some key sectors, and the leveraging of private sector financing for infrastructure, which can raise the growth potential of the economy.

Turning to Ecuador: dollarization has been working better than could reasonably have been expected. Having dollarized at a massively undervalued exchange rate, Ecuador had room for domestic wages and prices to rise. But the discipline of the dollarized system will become increasingly tight, and adjustment to changes in, say, the price of oil, will be difficult if fiscal discipline is not maintained, and if the domestic economy does not become more flexible. With oil prices high, the prospects for the balance of payments - which turned around in 1999 due to the massive recession - remain good. Growth is expected to be positive this year, and to be around 3.5 percent next year. This is good, but far from the rates required to make a decisive change in the economic situation of the people of Ecuador, and the need to continue the reform process therefore remains paramount.

On Brazil: the economy is enjoying a healthy recovery. Growth is projected at 4 per cent this year; the inflation targeting regime is working well and inflation should come in near the 6 per cent target; employment is rising; the exchange rate has been reasonaby stable; interest rates are at a six-year low; and social indicators are gradually improving. Who would have expected such a favorable performance 18 months ago?

Brazil's success is due to the determined pursuit of strong policies, for which the authorities deserve enormous credit: fiscal adjustment, the new flexible exchange rate-inflation targeting monetary regime, and strengthened structural reform efforts. Brazil has regained access to international capital markets. And the international support package provided in late 1998 has been largely repaid. Reserves now stand at $31bn, up from $24bn at the end of last year.

But while the financial vulnerability of the economy has been reduced, and there has been a decisive turnaround in performance, Brazil's public debt, its external debt service payments, and its current account deficit all point to the need for caution. The authorities need to consolidate fiscal adjustment and press ahead with additional reforms to promote domestic saving and export competitiveness. Macroeconomic policy needs to continue to support recovery, while avoiding any risk of overheating.

The Brazilian economy can grow on a sustainable basis significantly faster than it has in recent years. The extent to which that happens depends on the continuation and intensification of structural reforms. Progress so far with structural reform has been substantial, under difficult circumstances, with the reform of the social security system for private sector workers and the introduction of the fiscal responsibility law being particularly noteworthy. However, there is room for further progress. Reform legislation requires Congressional approval in a number of areas, including the regulation of private sector pension funds, social security contributions for retired civil servants, the reform of indirect taxation and the law on corporate governance. The privatization program also needs to regain momentum.

Sustained high level growth requires also more investment, not only in physical capital, but also in human capital. Physical investment requires the creation of an attractive investment climate - and that has been happening. As a large economy, Brazilian trade would naturally be a smaller share of GDP than for a smaller economy - but more needs to be done for Brazil to be integrated into global markets for goods and services. Investment in human capital requires policy decisions, and the administration's emphasis on investment in education is well placed indeed.

III. Longer-term issues for Latin America

As Latin America contemplates the twenty first century, a number of economic issues stand out. The first is monetary arrangements. Then I will take up in turn the fiscal framework, structural reforms, and income distribution and social inclusion.

Monetary arrangements

As countries in Latin America have moved to flexible exchange rates, they have had to search for new monetary anchors. In Latin America, as elsewhere, inflation targeting is the regime of choice. That is obvious in Brazil, but also in Chile and Colombia. In addition, Mexico is moving towards a formal inflation targeting regime.

Inflation targeting as a framework for monetary policy is an answer to many of the dilemmas of monetary policy that were wrestled with for nearly fifty years after the collapse of the gold standard. The framework is one of constrained discretion, in which the central bank is given a clearly defined goal, and the means to meet it. The framework has to be designed to take account of the two key short-run tradeoffs faced by monetary policy - between inflation and unemployment, and between inflation and the real exchange rate - and this can be done a variety of ways. Inflation targeting is not the last word on monetary policy for a country with a flexible exchange rate - nothing is ever the last word in our field, nor is it a very precise specific blueprint to be mechanically implemented. Rather it is a general approach to monetary policy, that has worked well in many countries and different circumstances.

For the longer term, the question remains of what currency regimes will be adopted in Latin America, and in particular, whether there will be fewer currencies. There is already one less in Latin America than there was last year at this time. In this crisis, we have seen the benefits Brazil derived from its flexible exchange rates, and the slower adjustment in Argentina with its hard peg. But the performance of a currency regime needs to be appraised by its average behavior over a period of years, not by how well it does in dealing with one particular type of shock.

I believe that over the longer run, the maintenance of a national currency for a small economy has few benefits and considerable disadvantages. Some of the disadvantages are emphasized in Ricardo Hausmann's argument that a small country with its own currency is committing the original sin. The strongest arguments in favor of a national currency are seigniorage and the easier adjustment that is possible with a flexible exchange rate when the real exchange rate has to change. These are powerful arguments, but I believe that if the Euro succeeds - and it will succeed - that we will gradually see fewer currencies. What precisely that means for Latin America, whether the use of the dollar, or the *real,* after a long period of stability, or a regional currency, is too far off to discern. The answer depends not only on Latin America, but also on the provisions the United States might be willing to make to encourage dollarization, for instance by finding ways to remit seigniorage to countries that adopt the dollar.

Any move to a regional currency would be more likely to succeed if it were the currency for a free trade area. And the question of what sorts of trade areas, hemispheric, or Latin American, will eventually predominate, is also an open question. It is exceedingly important that trade blocs should be built by reducing internal barriers, rather than raising external ones.

Fiscal frameworks

A number of Latin American countries have introduced fiscal responsibility laws. By imposing statutory constraints on the operation of fiscal policy, they hope to increase credibility in the same way that adoption of central bank independence and inflation targeting has increased credibility in the monetary sphere.

In Argentina, the Law on Fiscal Solvency introduced in September 1999 requires the federal government to maintain a balanced budget from 2003, and also to ensure that spending does not run ahead of economic growth. It also establishes a stabilization fund to mitigate the impact of the economic cycle on the budget. In Peru, the Law on Fiscal Prudence and Transparency enacted in December 1999 also establishes the general principle of a balanced budget and a constraint on spending growth. The rules can be waived in the event of national emergency, international crisis or a recession. It also establishes a stabilization fund. In Brazil, the Fiscal Responsibility Law approved this year requires each tier of government to maintain current balance, limit spending on personnel and keep the ratio of debt to current revenue within limits set by the Senate, on the President's proposal.

Each country's legislation increases the transparency of fiscal policy, requiring public disclosure of targets and outcomes. This information has to conform to generally established accounting principles. Compliance with the rules is subject to surveillance by the legislature, helped by quasi-independent auditing offices.

These laws are welcome. But the proof of the pudding is in the eating. Ultimately, investors and lenders will only be impressed by a good track record. It remains to be seen how these laws will be implemented when times get tough.

Structural reforms

In addition to fiscal reform, Latin America needs to consolidate or push ahead with structural reforms in a number of other areas:

- Further reforming labor markets to promote job creation. Liberalization is better than increasing public sector employment to generate employment.
- Maintaining and developing good relations with private creditors, to help guard against crises and make them easier to deal with when they cannot be avoided.
- Promoting good governance - including through the adoption of international standards.
- Strengthening financial systems.

- Continuing to make progress in opening trading systems and resisting recent protectionist pressures. The importance of trade policy is hard to exaggerate.

Inequality and social inclusion

Sound macroeconomic policies and the intensification of structural reforms are essential if countries are to grow sustainably at higher rates. To continue reforms year after year is politically difficult, and adjustment fatigue sets in from time to time. One of the saddest lessons of economic development is how quickly hard-won reform and growth achievements can be thrown away - and adjustment fatigue can thus be deadly.

But adjustment fatigue is a political phenomenon, and if public support for pro-growth, pro-market policies is to be maintained, more people need to feel the benefits.

This means tackling inequality. Latin America has greater income inequality than any other region in the world.

The richest decile receive 40 per cent of national income, compared to less than 30 per cent in the US. More than a third of the population live below the poverty line. Income distribution improved in the 1970s, but gains were wiped out after the debt crisis. As high inflation has been tamed, structural reforms implemented and growth restored in the 1990s, middle-income groups have gained relative to rich and poor.

Inequality is high in part because Latin America has been relatively vulnerable to crises, in part because of reliance on commodity exports, in part because this has not been a focus of public policy. The poor are less able to weather shocks and may be forced into actions (e.g. in education and health) that limit they and their children's long-term earning power. No-one should underestimate the political difficulty of addressing these issues, or of the inadequate state of our knowledge about how to do so. But unless economic policy in Latin America turns to this issue, growth will not be sustained.

Policies to address this critical issue include:

- Better social safety nets
- Avoidance of unnecessarily abrupt macro adjustments
- Removing labor regulations benefiting insiders
- Targeted education and health care support

- Improved public services to allow more women to work
- Measures to make credit more widely available
- Fully-funded pension schemes to increase the pool of savings.

When told that the North American wars would ruin Britain, Adam Smith replied "there is much ruin in a nation". Unfortunately, there is also much reform needed in a nation. The reform agenda is long and difficult. But some countries are well on the road to achieving sustainable growth. Growth is more likely to be sustainable if it is high quality growth. And that is the challenge for political and economic leadership in Latin America, where so much has been achieved in many countries in recent years.

Thank you.

1 Views presented are those of the author and not necessarily of the IMF. I am grateful to Claudio Loser, Teresa TerTer-Minassian, and Robert Chote for their assistance.

IMF EXTERNAL RELATIONS DEPARTMENT
Public Affairs: 202-623-7300 - Fax: 202-623-6278
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