



# Latin America in the New Global Order

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# Outline

1. Economic and social performance of Latin American economies.
2. The causes of Latin America poor performance: too much unfinished work?
3. Challenges for Latin America in the new global era.

# 1. Economic and Social Performance of LAC Economies

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- In the three decades after WW II Latin American economies experienced steady growth (about 5% p.a.).
- This performance was interrupted by the debt crisis of the early 1980s.
- The crisis uncovered the serious structural problems existing in most Latin American economies and motivated reform attempts.

# 1. Economic and Social Performance of LAC Economies

- As a result, after the crisis the “old” import substitution-cum-government intervention development model started to be abandoned (Chile started a decade earlier).
- At different pace, countries began introducing deep reforms and policies that put emphasis on macro stability, competitive market structures, integration into the world economy and a new role for the government.

# 1. Economic and Social Performance of LAC Economies

- The “new” economic model was expected to accelerate growth and to improve social indicators (reduce poverty and income inequality).
  - Except for Chile, the reform process roughly coincides with the return of private capital inflows to the region.
- However, the results have been mixed: few countries have achieved stability and higher growth.

# 1. Economic and Social Performance of LAC Economies

- With regards to economic growth:
  - Latin America had its worst decade during the 1980s (the so called “*lost decade*”);
  - In the 1990s economic growth resumed, but remained below the rates prevailing in the pre-crisis years;
  - During this period Chile was the fastest growing economy in LAC (it was among the fastest growing economies in the world: 7.3% p.a during 1985-97).

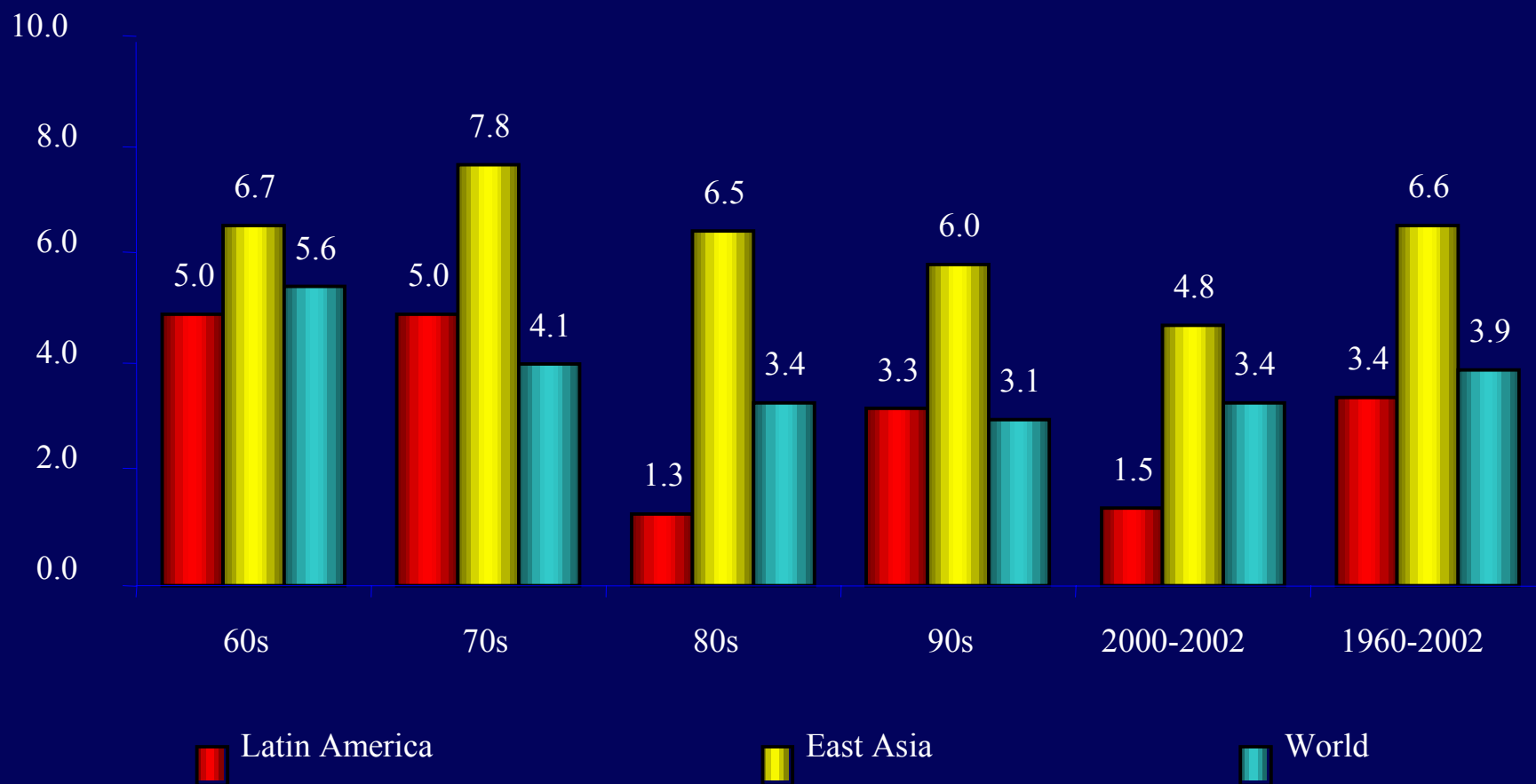


# 1. Economic and Social Performance of LAC Economies

- Except for Chile, during the '80s and '90s most Latin American countries saw an increase in the gap in per-capita GDP with medium- and high-income countries;
  - In the past twenty years Chile reduced in about 25-30% the gap in per-capita GDP with the U.S.;
- Neither we observe convergence (absolute) among Latin American countries during the 90s;
- But trade openness of LA countries has increased during the past three decades;

# Economic Growth

(1960-2002, %)

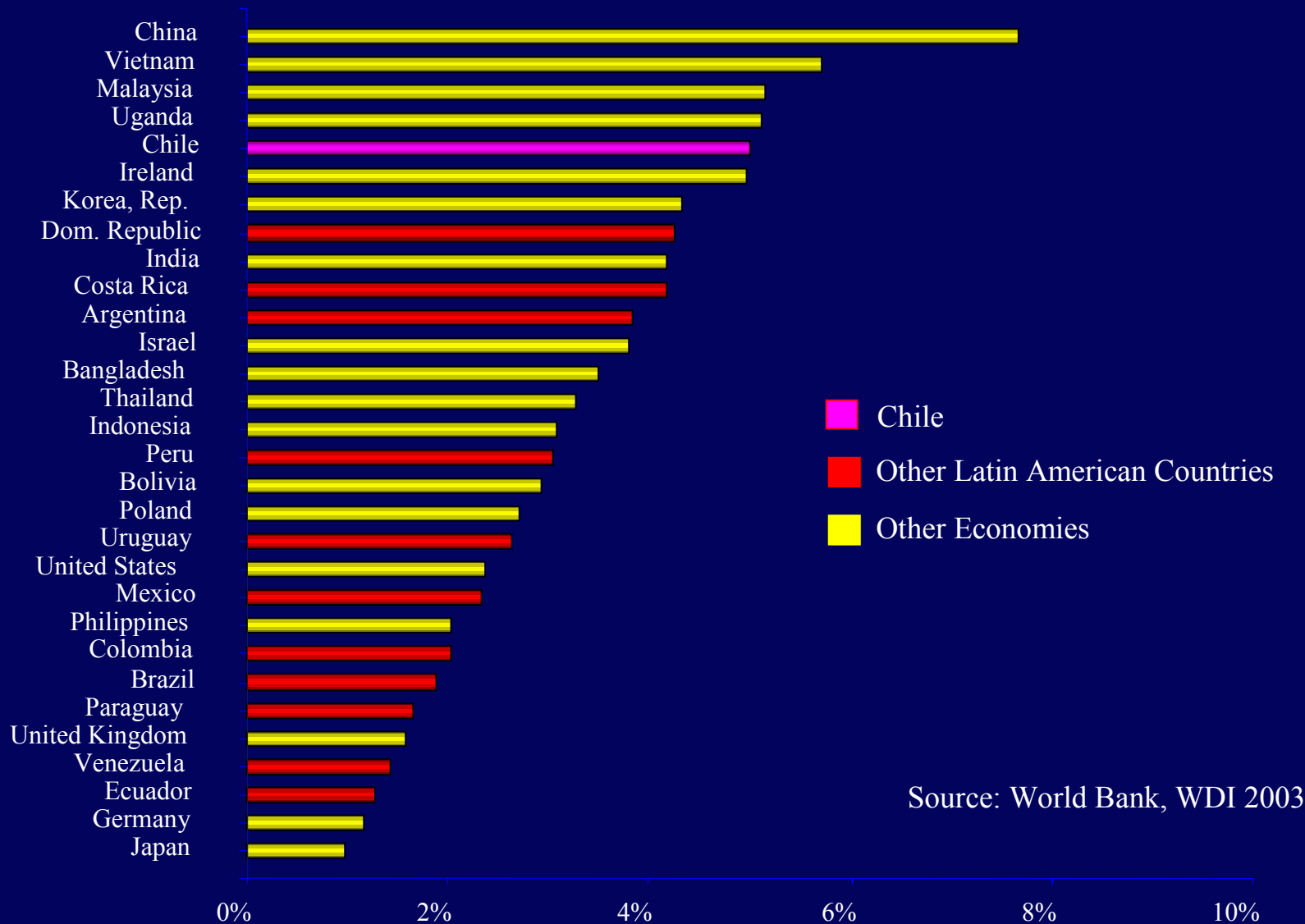


Note: East Asia includes China, Hong Kong, Indonesia, Korea, Malaysia, Philippines and Thailand.

Source: World Development Indicators (2003) and IMF (2003).

# Economic Growth During the 1990s

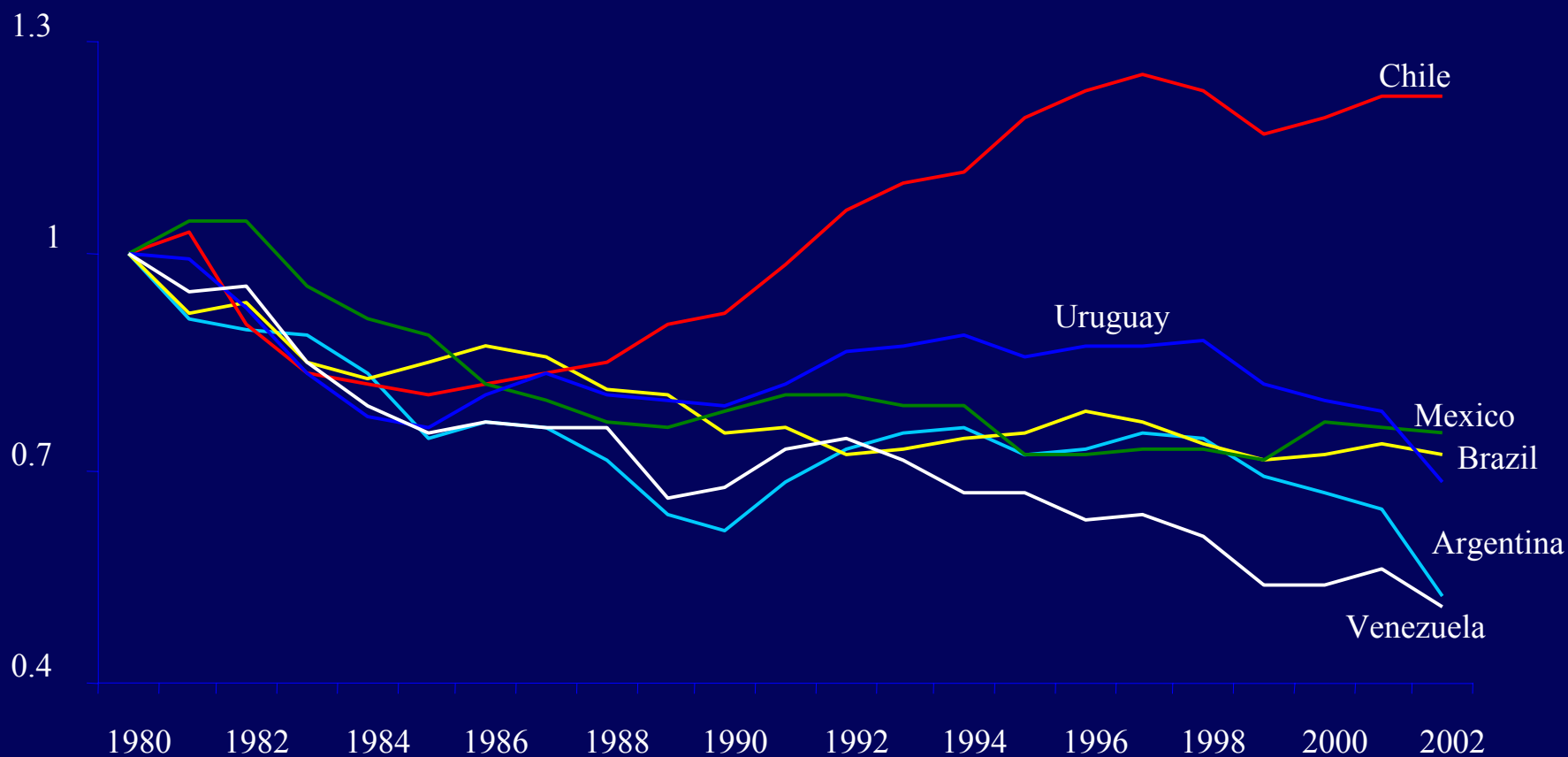
*(selected countries)*



Source: World Bank, WDI 2003

# Relative Gross Domestic Output

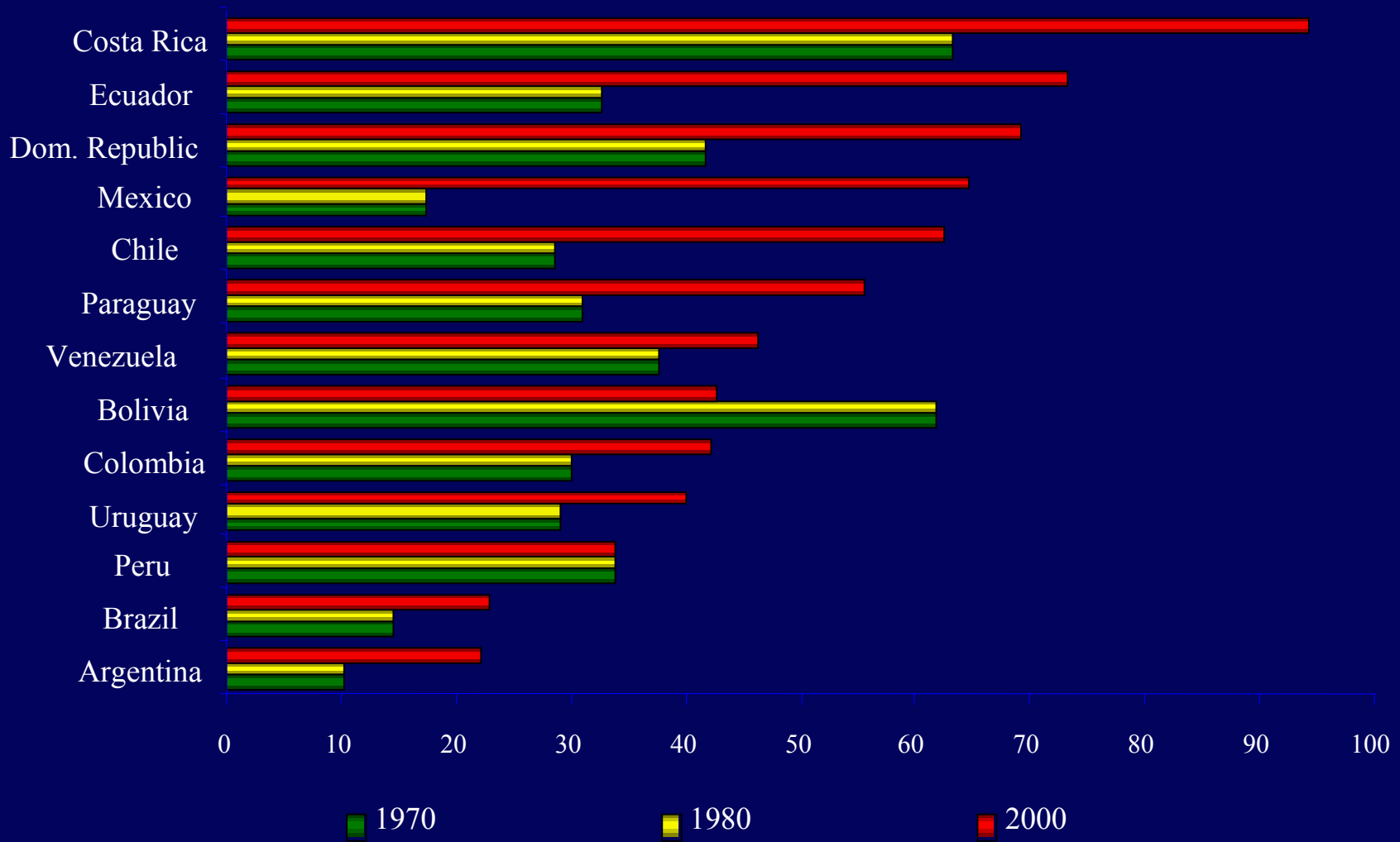
*(Country j per-capita GDP over USA per-capita GDP; 1980=1)*



Source: IMF, WEO Database, 2003

# Trade Openness

$\% (X+M)/GDP$

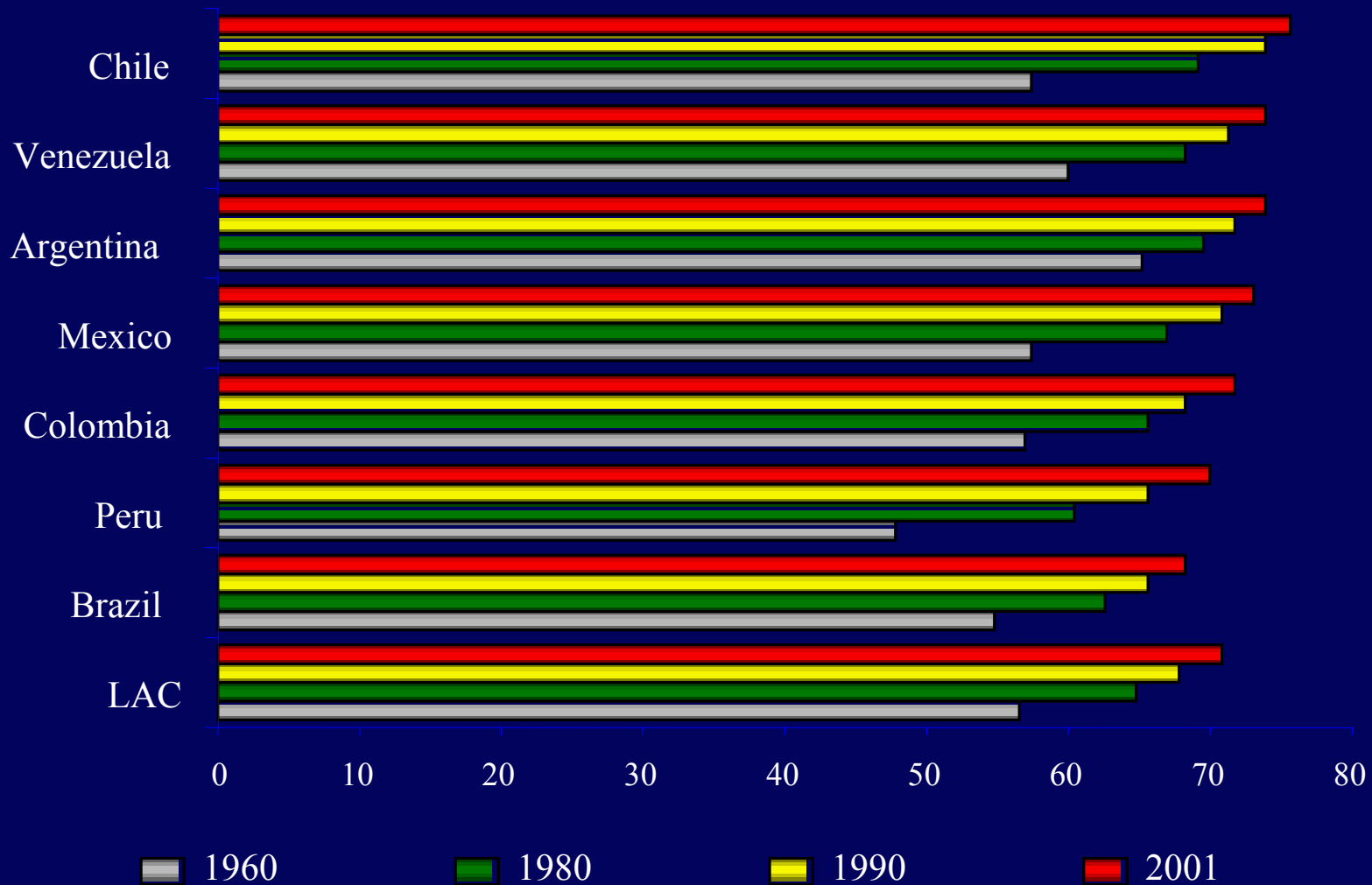


# 1. Economic and Social Performance of LAC Economies

- With regards to social indicators:
  - Life expectancy, literacy rate and infant mortality improved remarkably since the 60s, even during the debt crisis period;
  - Poverty reduction has been rather modest and uneven:
    - Chile and Uruguay achieved the greatest reduction;
    - In some countries poverty increased (Mexico, Peru and Venezuela).
  - Income distribution has deteriorated, becoming one of the worst in the world.
    - In this matter Chile is not an exception.

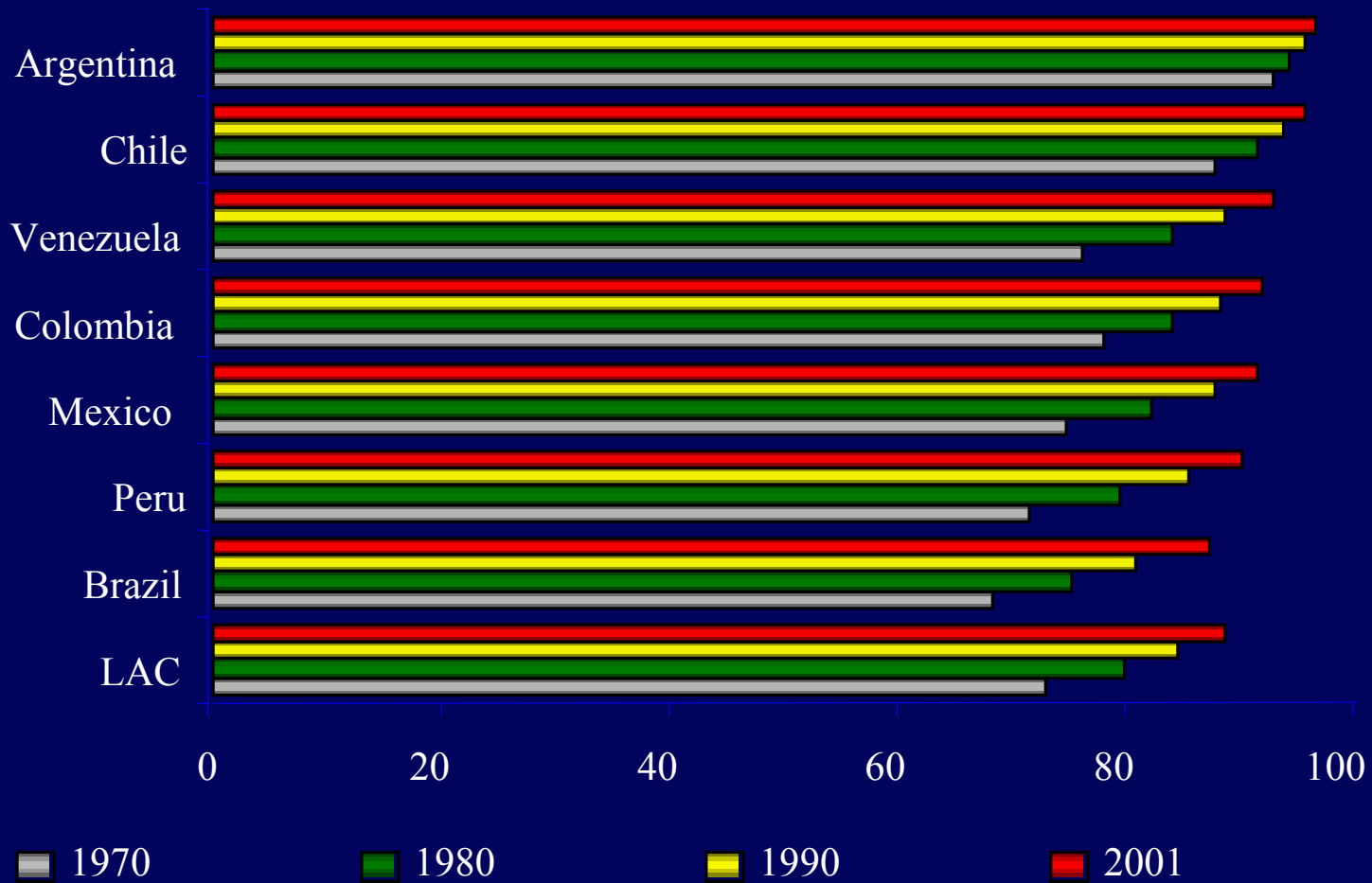
# Life Expectancy at Birth

(number of years)



# Literacy Rate

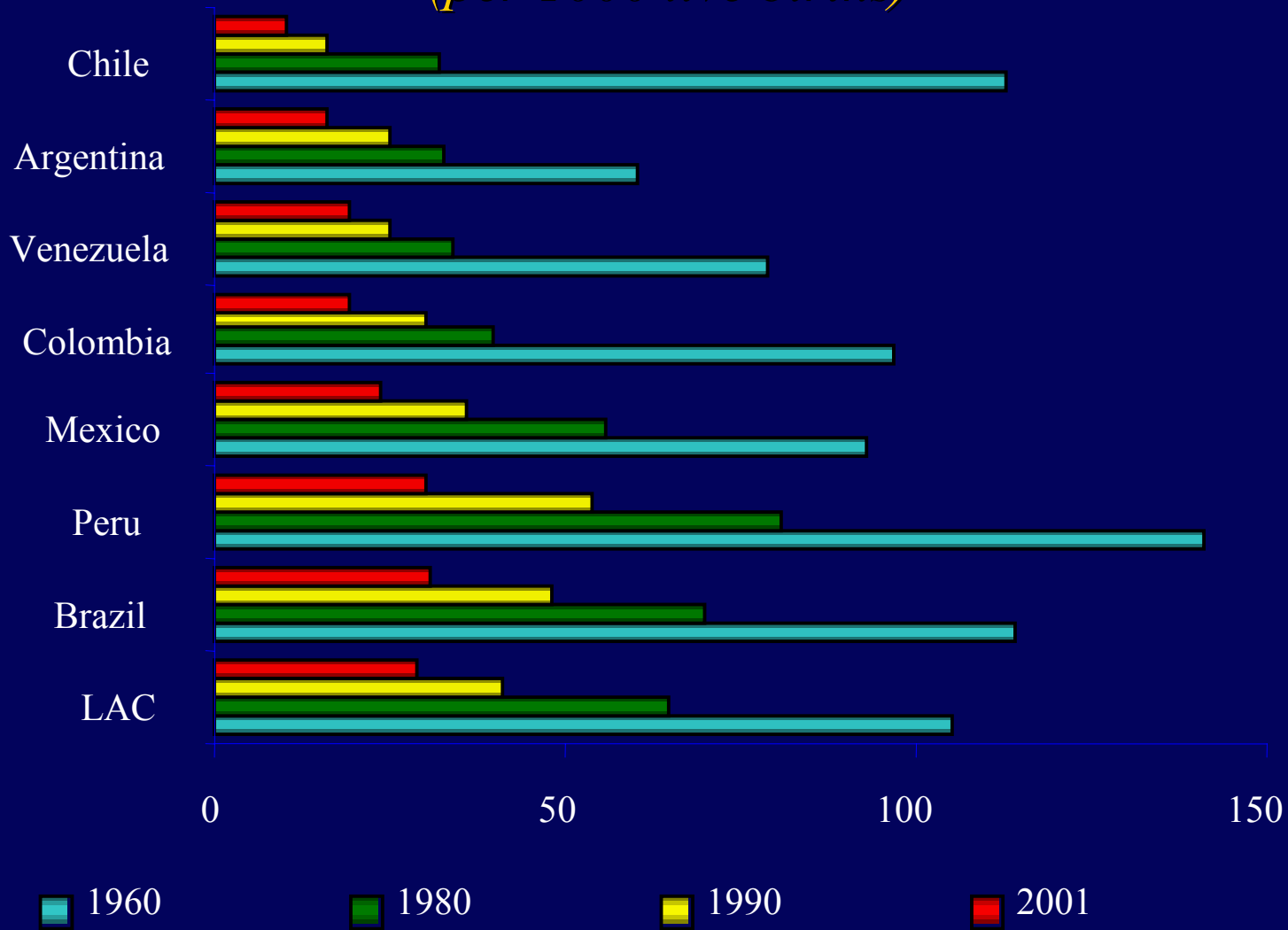
*(percentage)*



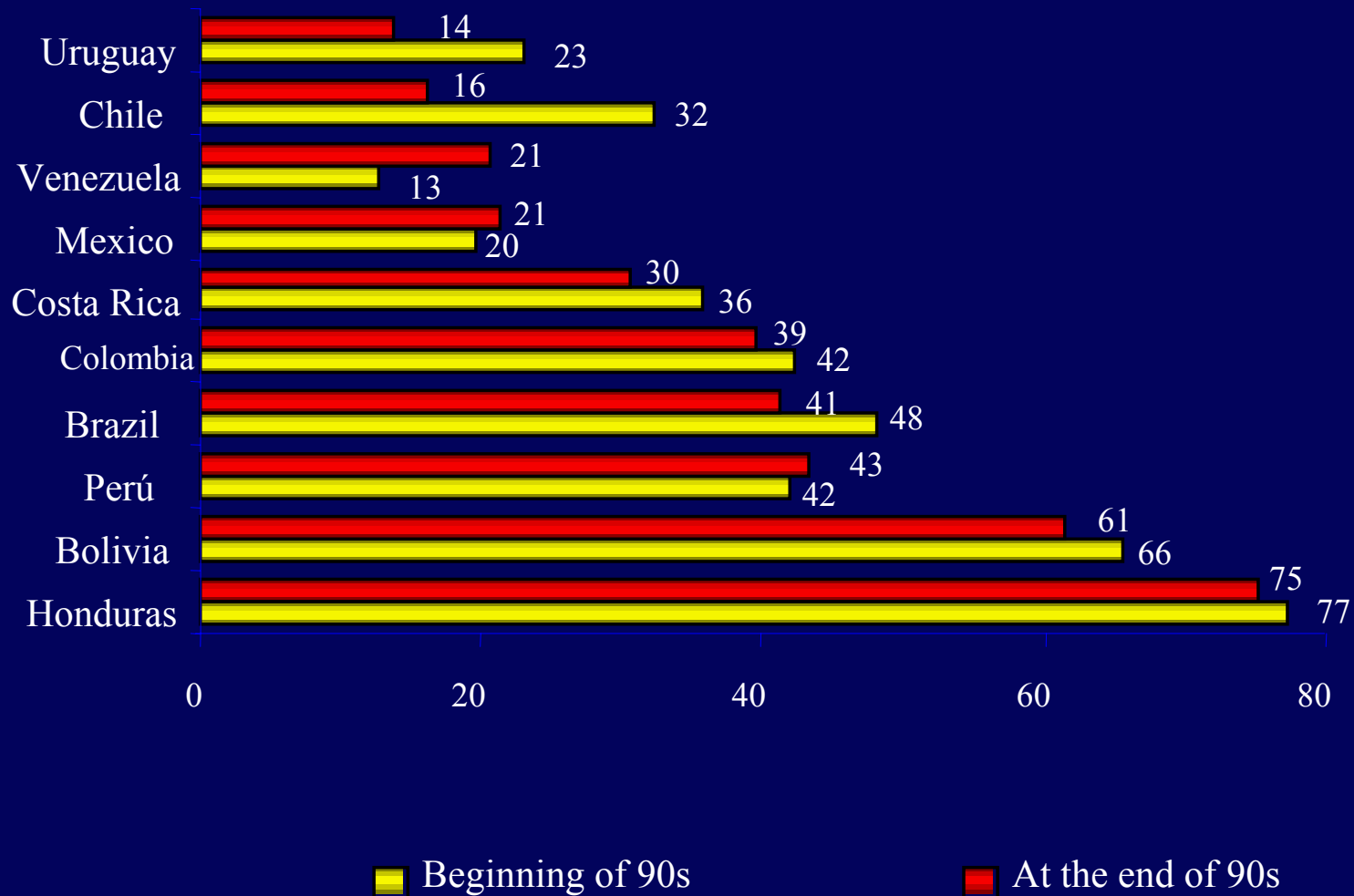


# Infant Mortality

*(per 1000 live births)*



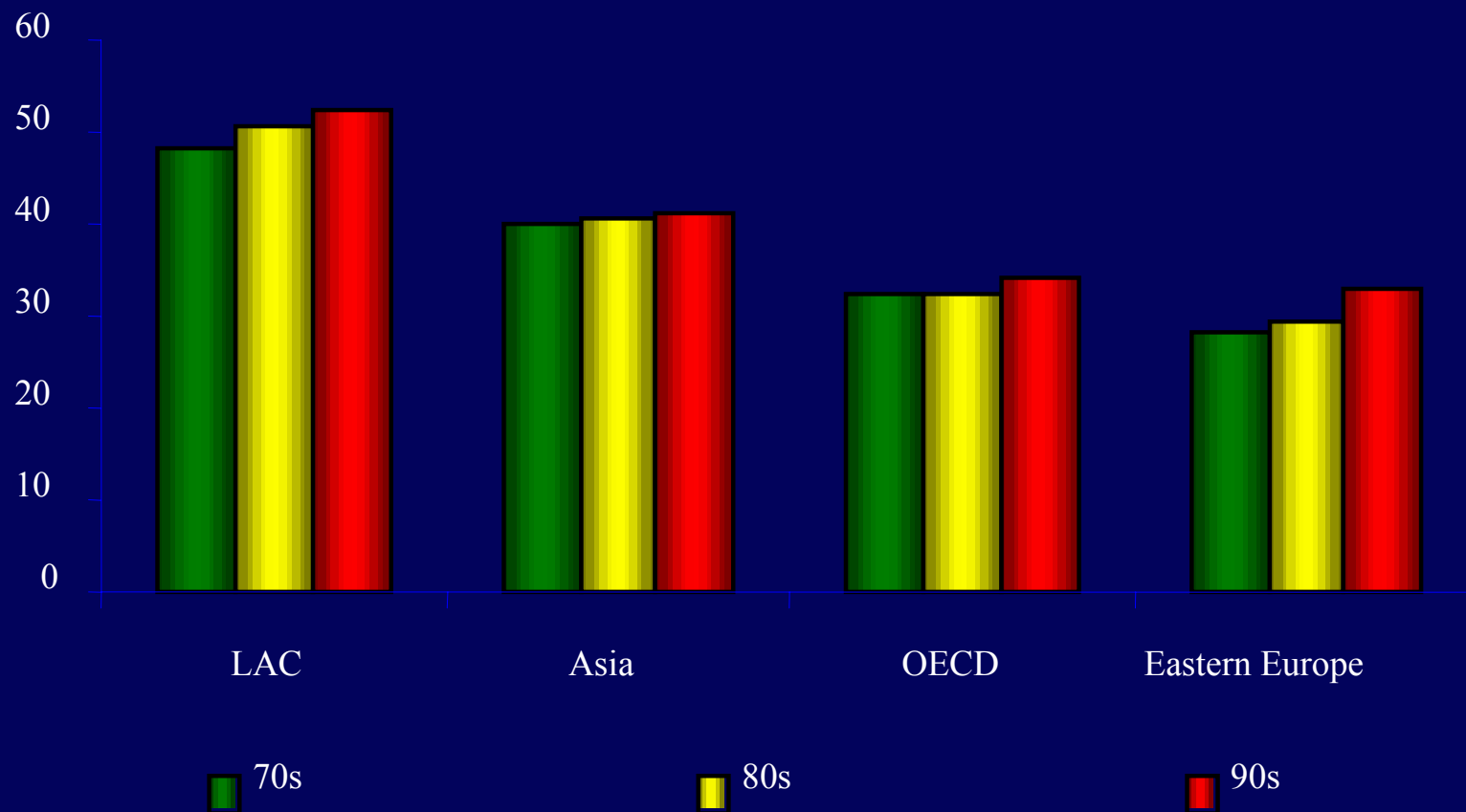
# Poverty Rate



Source: Székely (2001)

# Income Distribution

*(Gini coefficients)*



# 1. Economic and Social Performance of LAC Economies

- In sum, we can conclude:
  - The economic and social performance of most Latin American economies after the reforms has been disappointing:
    - Economic growth has not reached the pre-crisis rates;
    - The reduction in poverty rates has been modest;
    - Income distribution is one of the worst around the world.
  - Except for income distribution, where like in most Latin American countries there has not been any improvement, Chile is the “exception to the rule”.

# 1. Economic and Social Performance of LAC Economies

- Up to this point, important questions arise:
  - Why the payoffs of the reforms have been so disappointing?
  - What is so particular about Chile?

## 2. Searching for Explanations

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- One common feature of the region has been the high propensity of countries to incur in macroeconomic crises.
- The macro crises have delayed the reform process and in many cases resulted in set backs.
- Macro crises have fiscal roots and in some countries they have been exacerbated by financial crises.
- Reforms without appropriate macro underpinnings have resulted in perverse responses.

## 2. Searching for Explanations

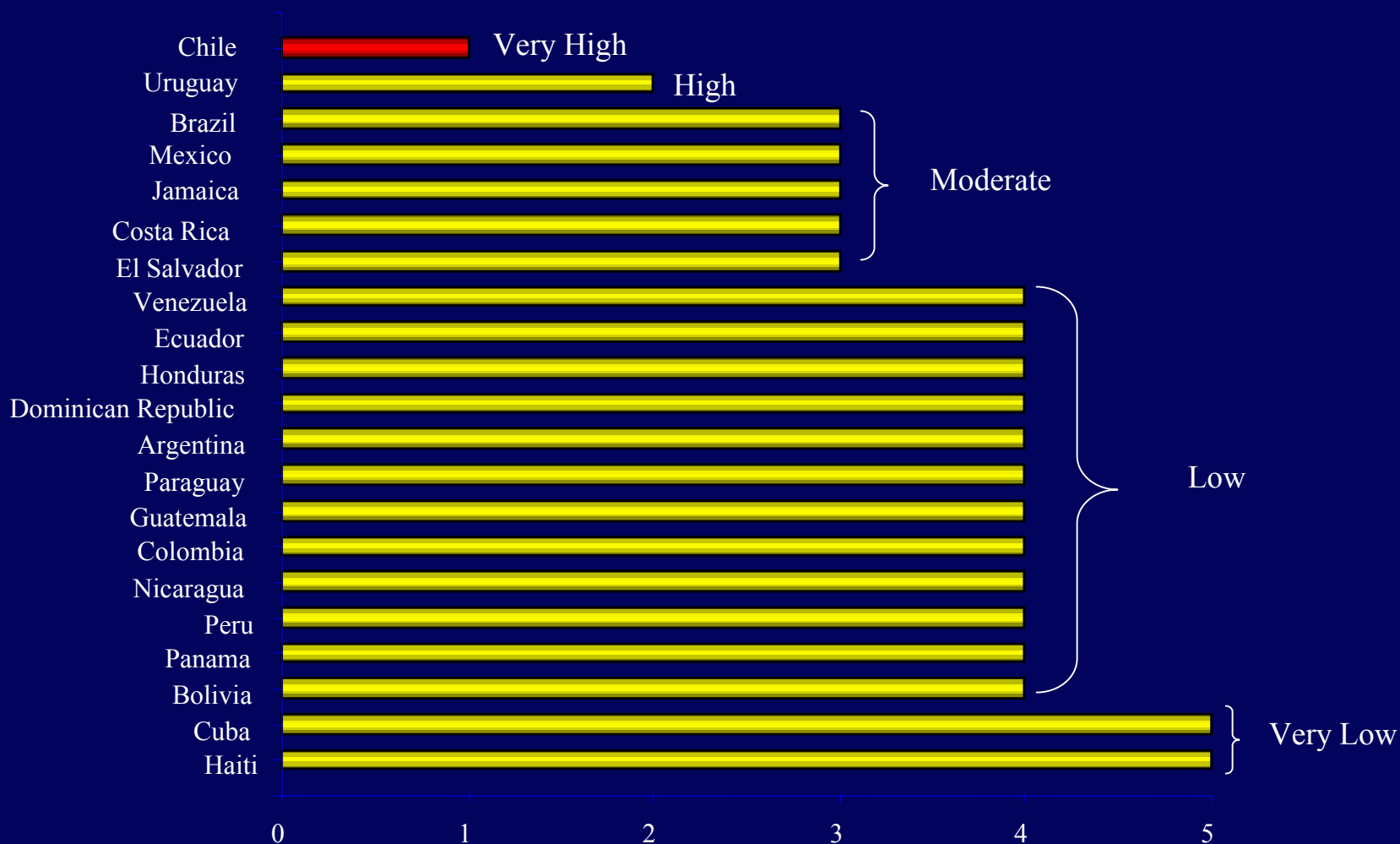
- What is so different about Chile?
  - In Chile fiscal problems were faced early on, culminating with stringent fiscal responsibility;
  - The opening up process (albeit short lived setbacks) has been a continuous one for the past 30 years;
  - And reforms have gone well beyond macro and trade, emphasizing also the institutional buildup;
  - As a result Chile's fundamentals are very solid and the country is more resilient to shocks.



## 2. Searching for Explanations

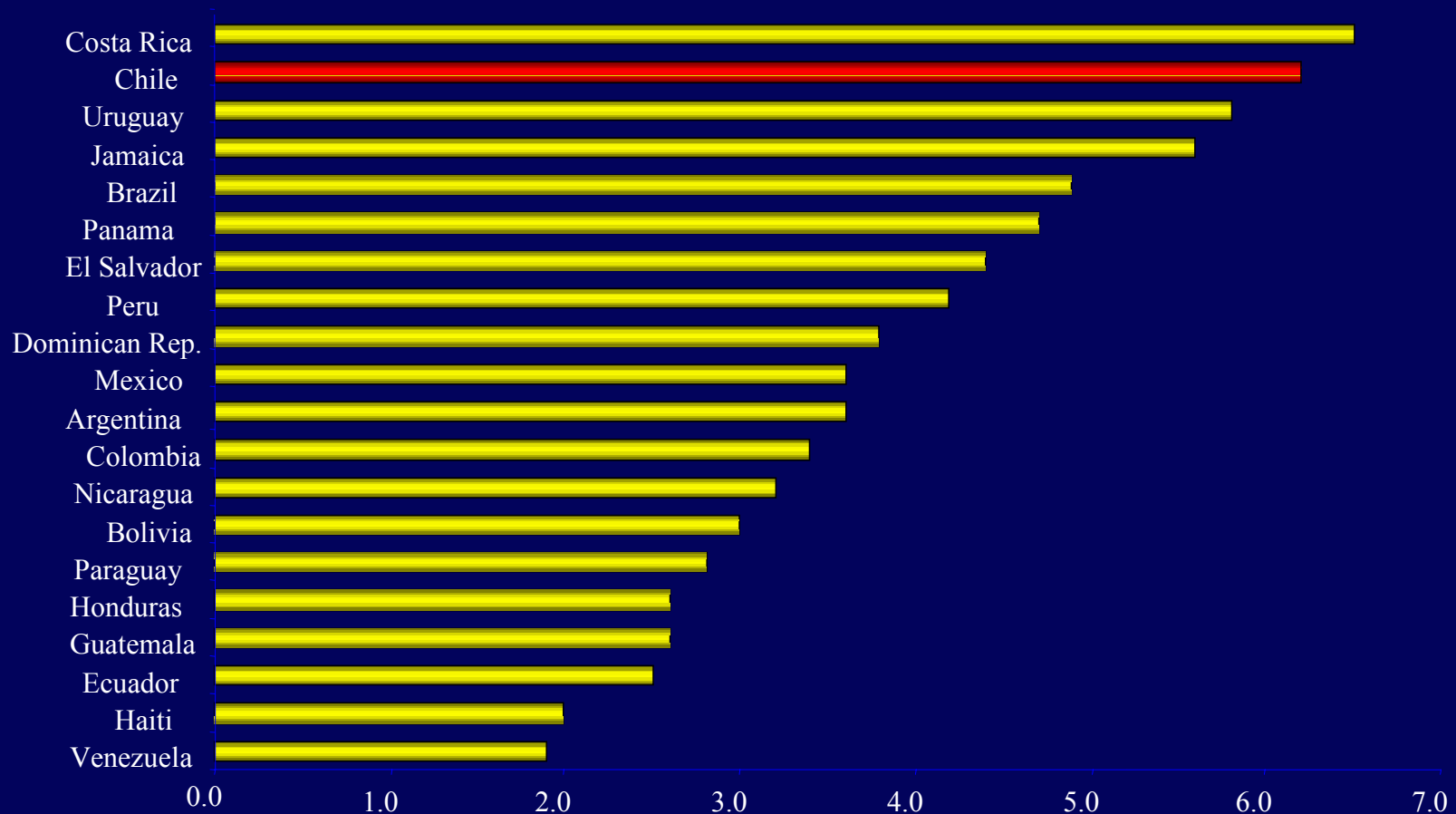
- The breath of reforms:
  - Competition/privatization;
  - Pension system;
  - But even more important, there has been an important institutional buildup:
    - Property rights;
    - Framework for private sector participation in infrastructure through BOT arrangements;
    - Banking and bankruptcy laws;
    - Independent central bank;
    - Fiscal rule.

# Respect of Property Rights

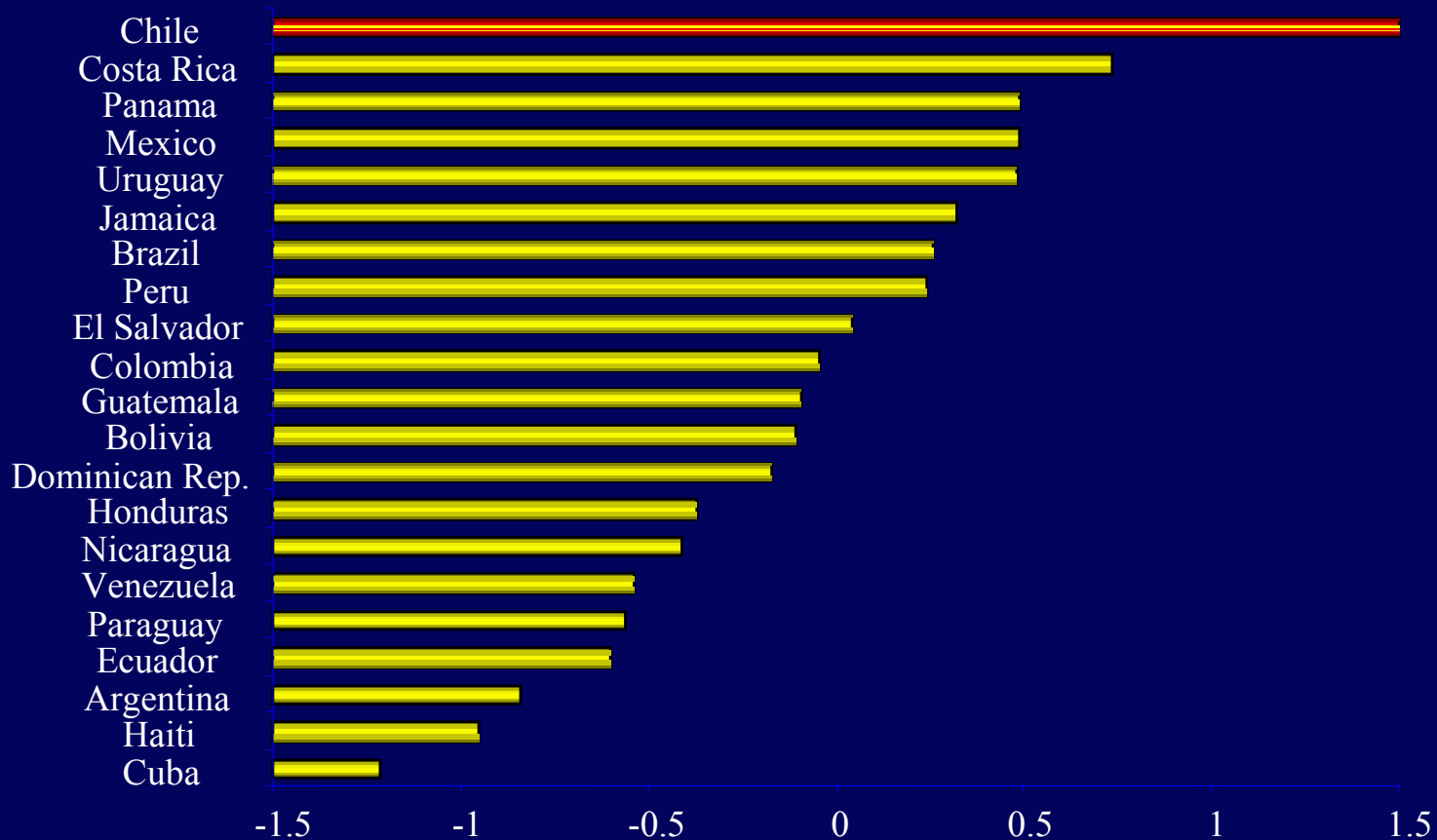


Source: Heritage (2004)

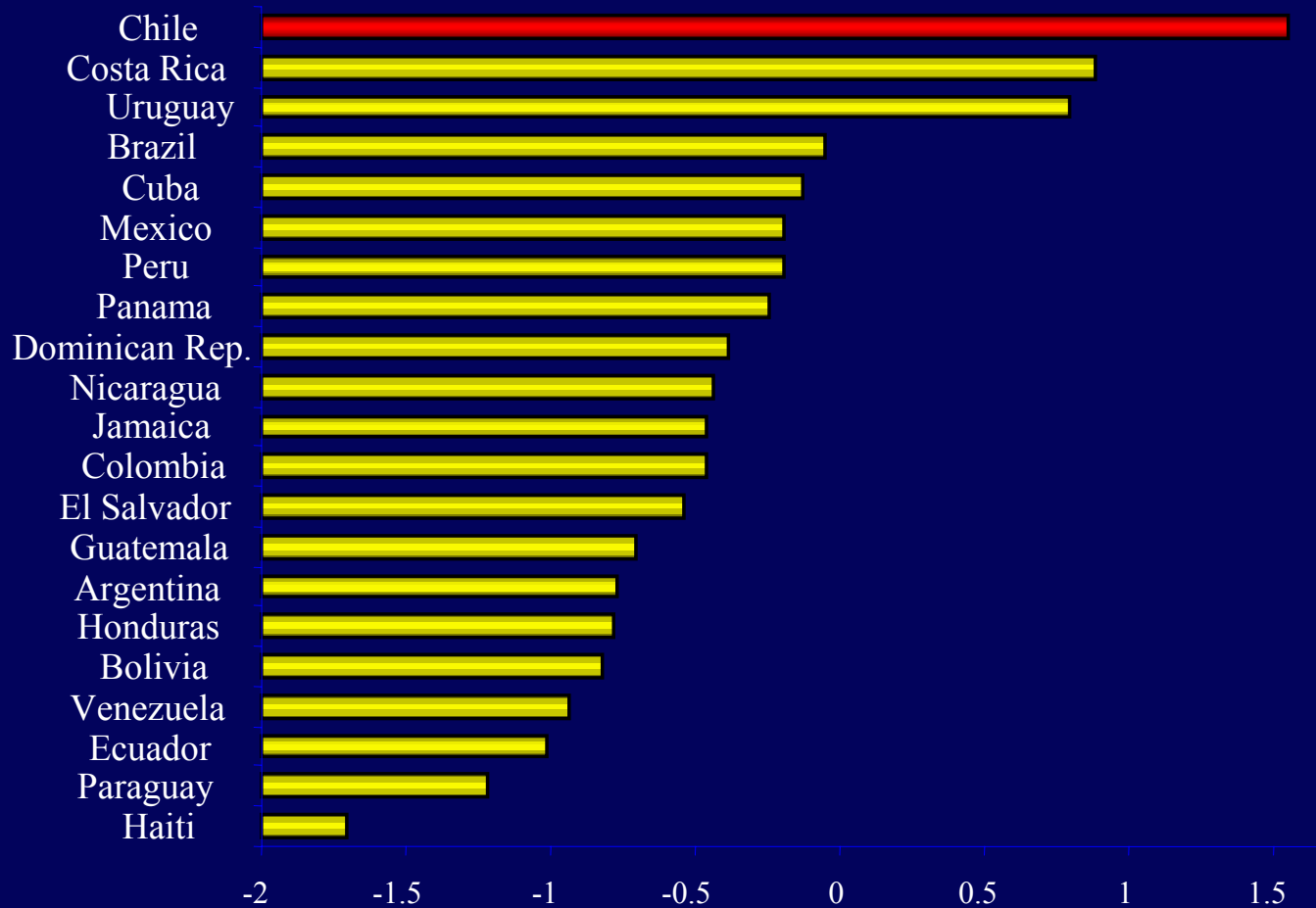
# Legal Structure and Security of Property Rights (as of 2001)



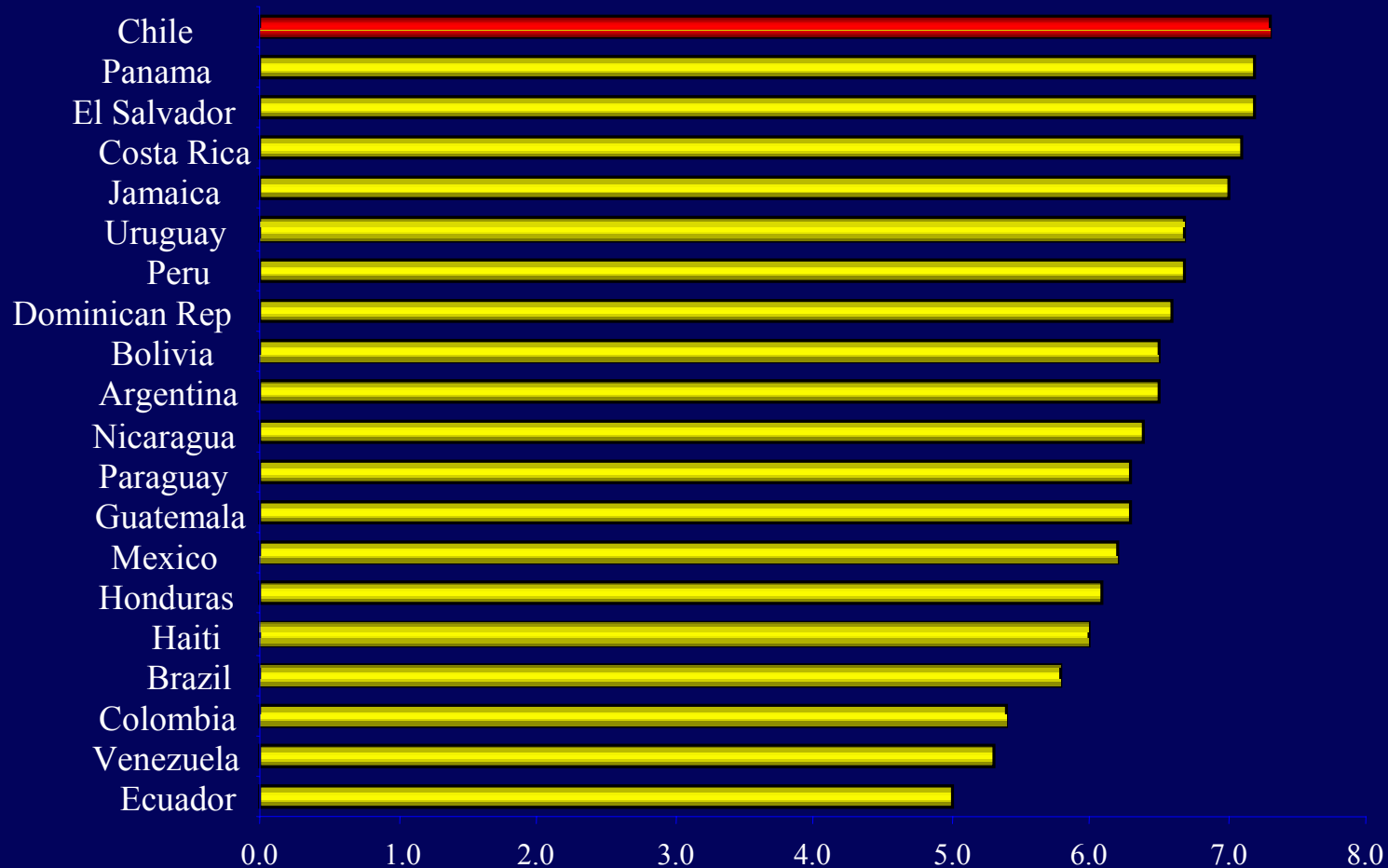
# Regulatory Quality



# Control of Corruption



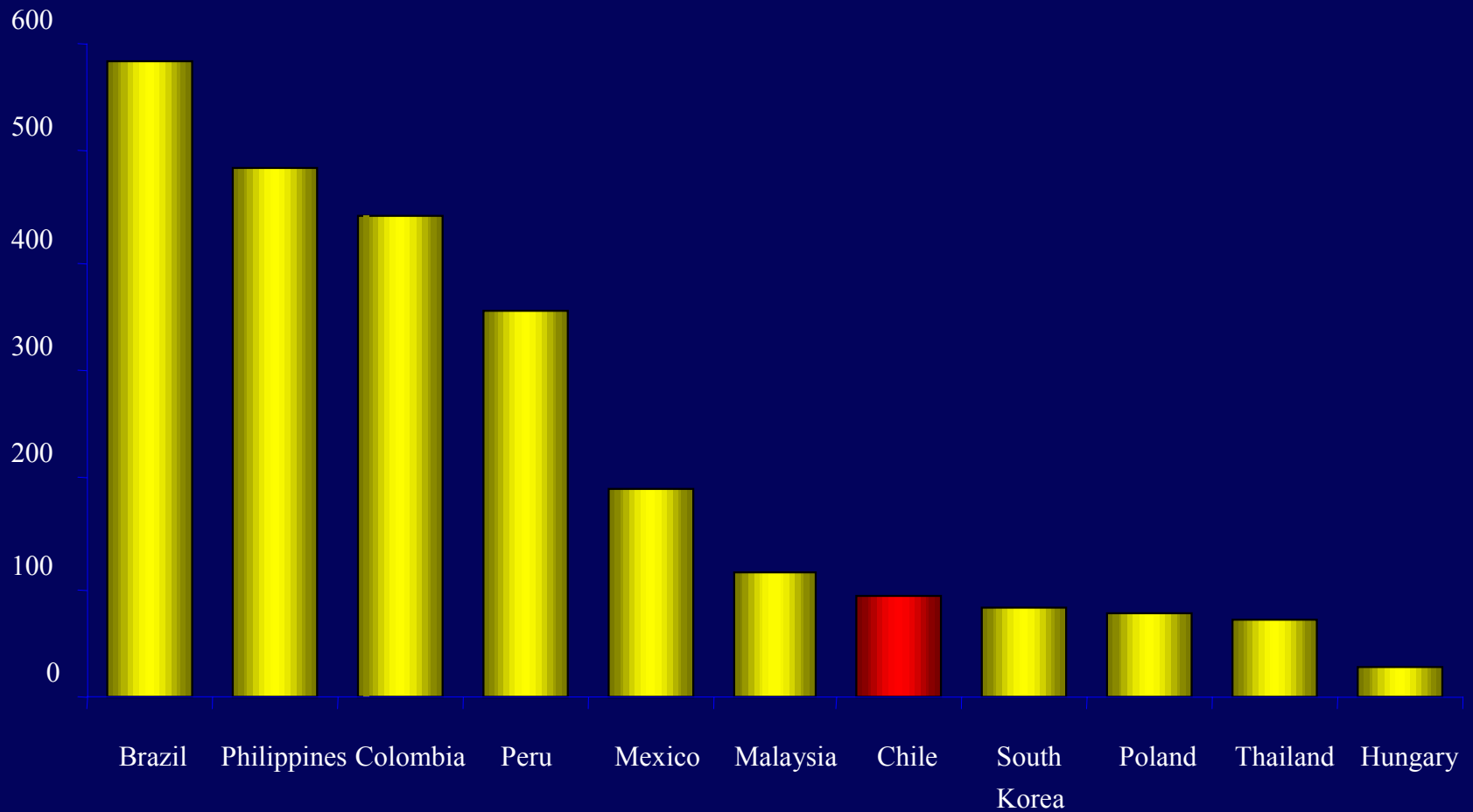
# Economic Freedom (as of 2001)



Source: Fraser Institute.

# Country Risk

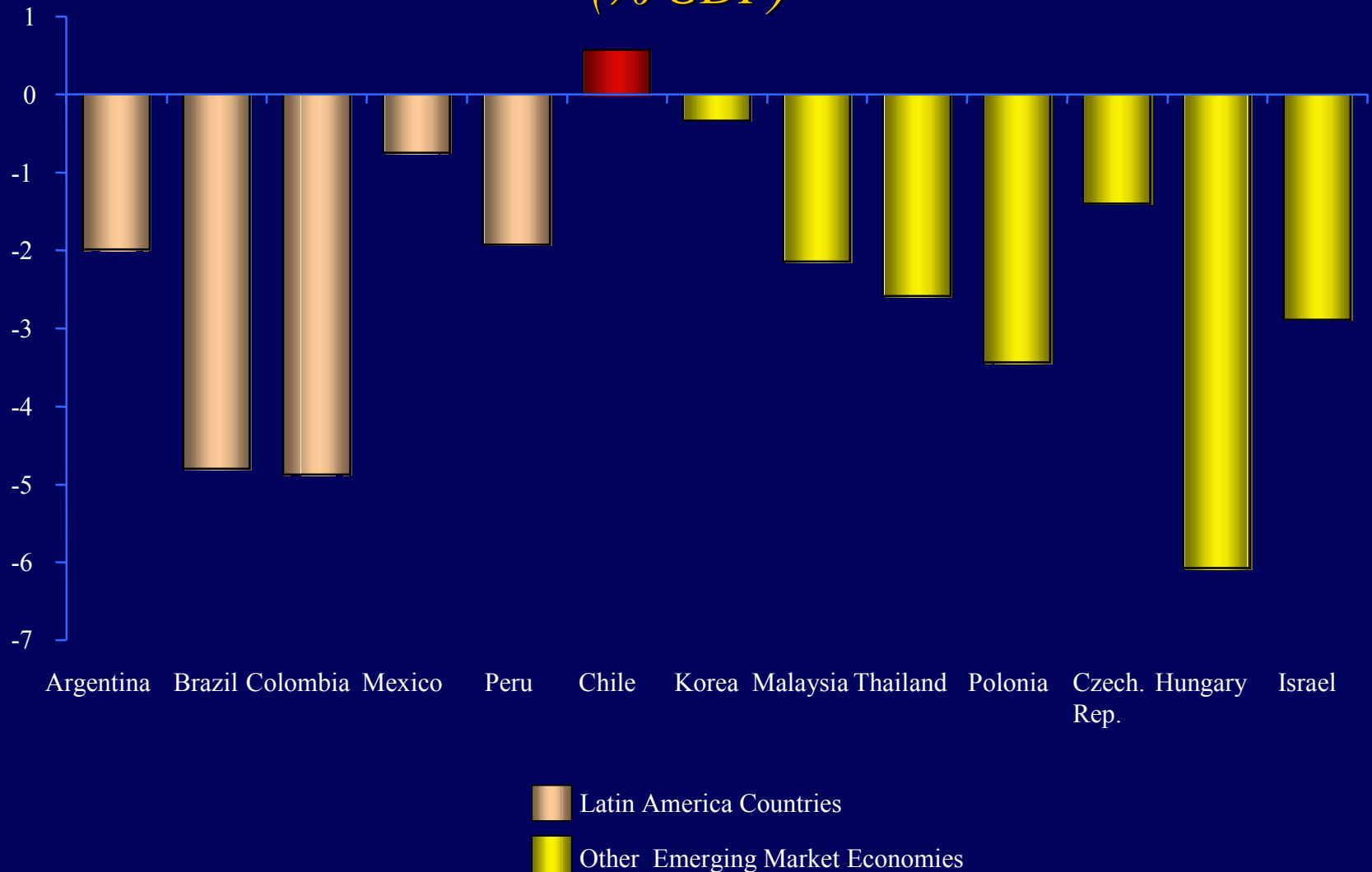
*(Basis Points)*



Source: JP Morgan, February 2004

# Fiscal Balance: Average 1995-2002

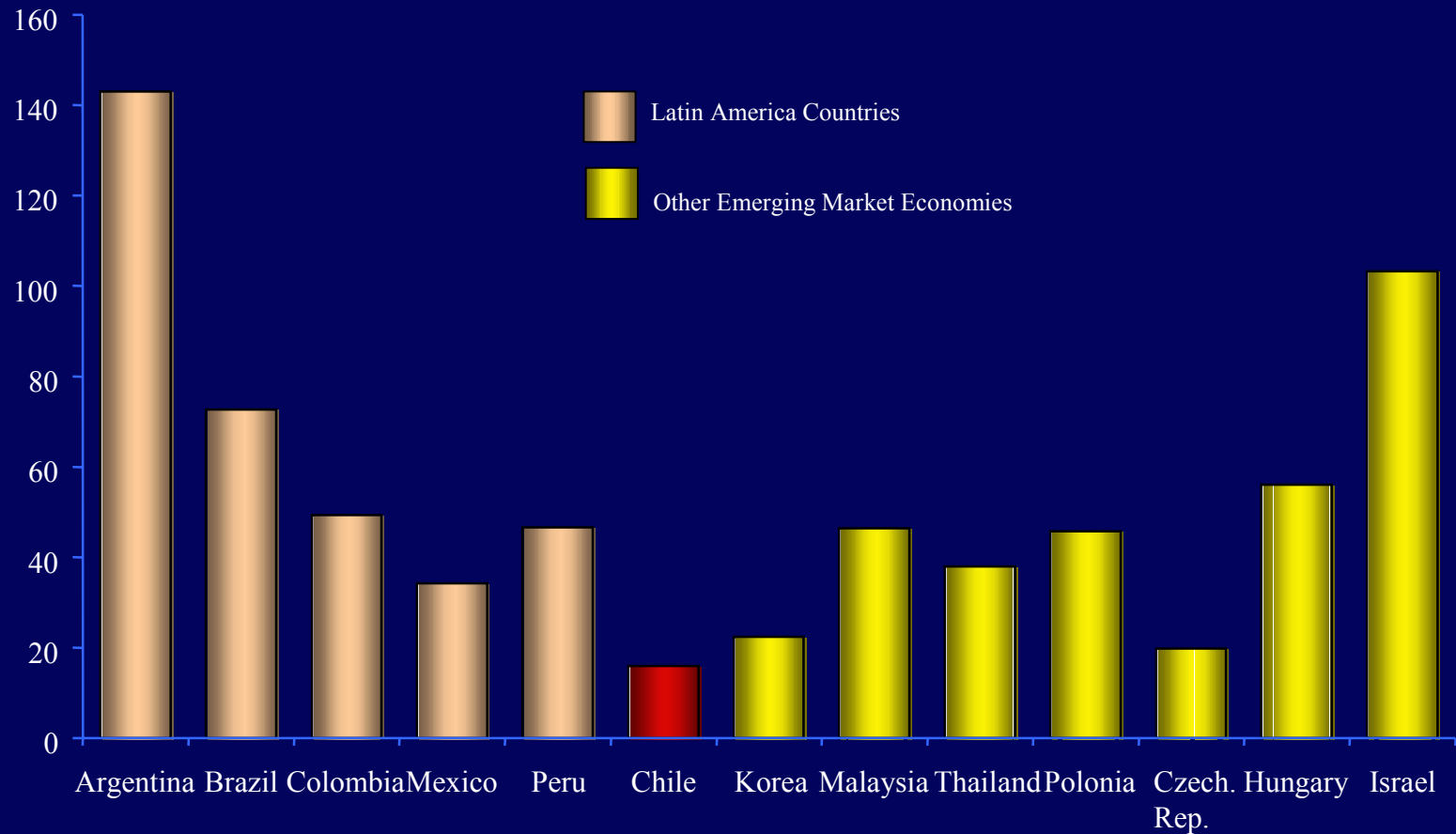
(% GDP)





# Public Debt 2002

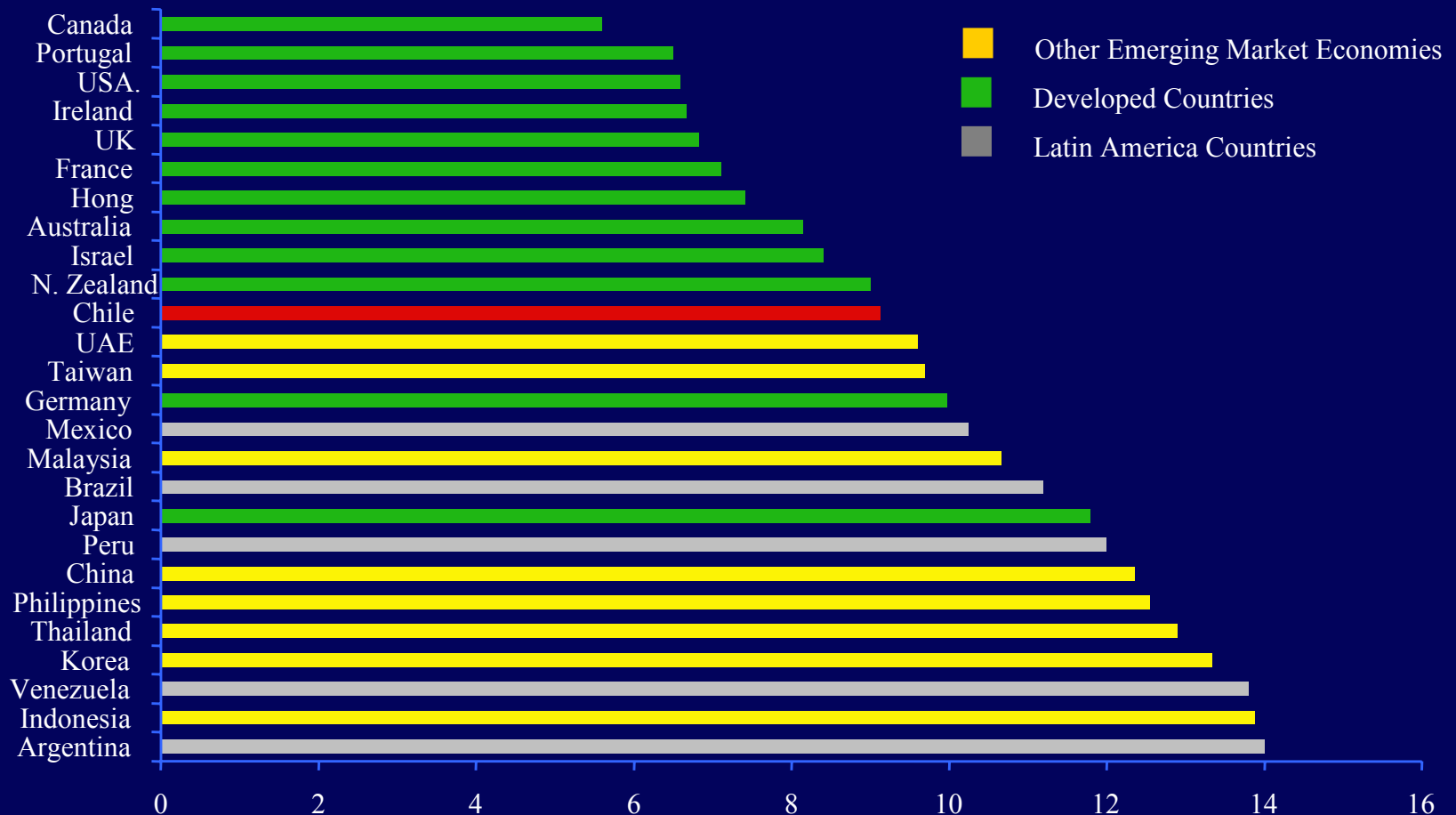
(% GDP)



(1) Gross central government debt (excludes debt from the central bank and social security trust funds)

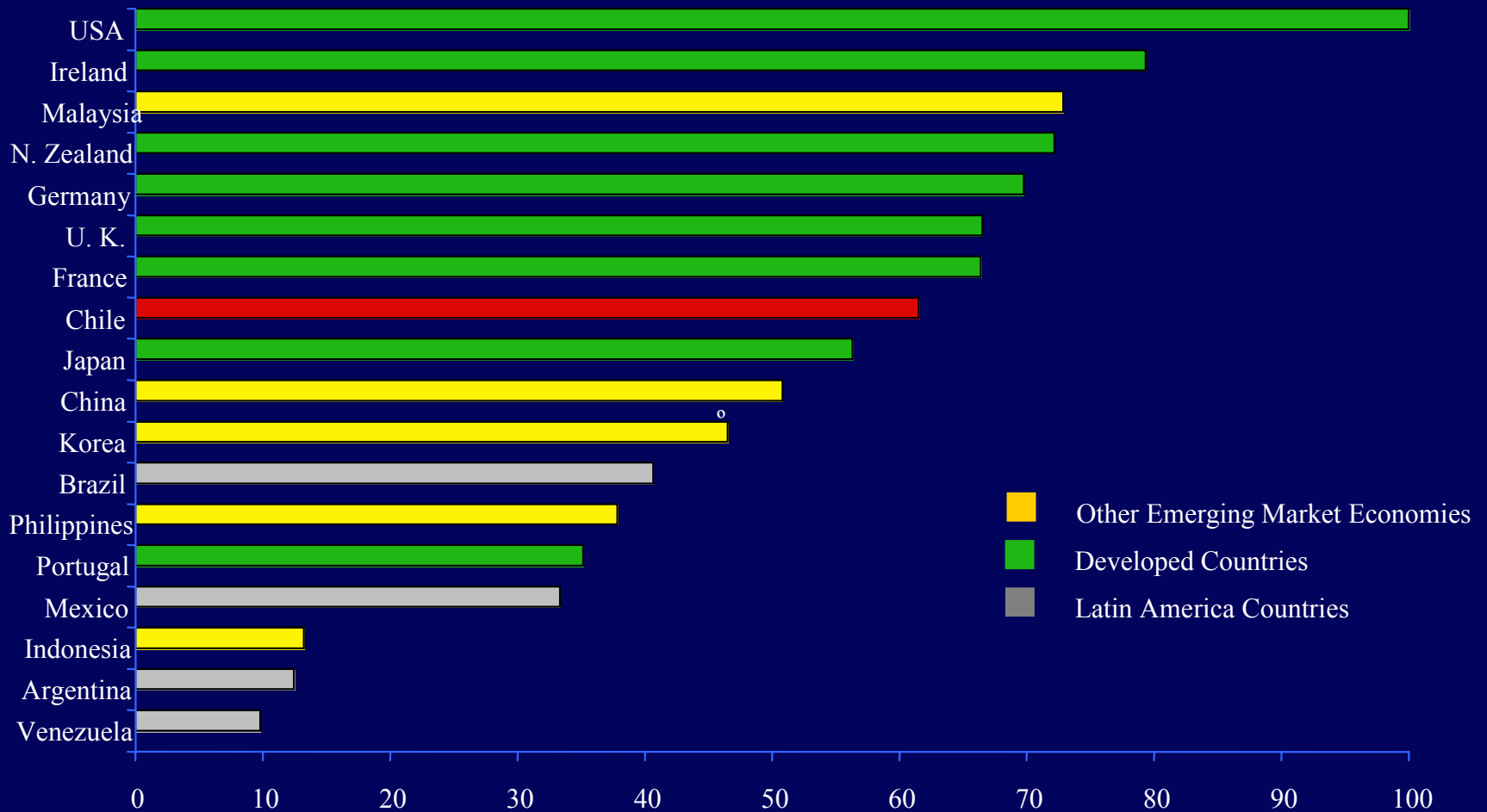
Source: Moody's April 2003, and Ministry of Finance

# Ranking of Banking Strength



Source: Moody's, March 2003.

# Competitiveness Ranking 2003



Source: IMD, May 2003.

### 3. Challenges for Latin America in the New Global Era

### 3. Challenges for Latin America

- The new global era represents a great opportunity for the Latin American region:
  - It gives access to better consumption opportunities and greater technological possibilities;
  - It improves future prospects.
- However, it also presents great challenges:
  - Countries with poor institutions and bad policies are more vulnerable to financial crisis and increasingly subject to contagion effects;
  - New technologies are biased towards high-skilled labor, which may exacerbate income inequality and be the cause of social unrest.

# 3. Challenges for Latin America

- The main challenges for the Latin American countries are:
  - to develop institutions and implement policies that make our economies more resilient to external shocks and, at the same time, set the basis for achieving high and sustainable growth (this can make the difference between those countries that will gain or lose from the irreversible globalization trend);
  - implement policies aimed at reducing the existing income inequality.

### 3. Challenges for Latin America

- What do we know with regards to macro policy:
  - Fiscal responsibility is a must and financial systems need to be strengthened;
  - On the exchange rate system:
    - **Adjustable pegs** are prone to speculative attacks and flexibility helps;
    - Capital controls have demonstrated to be ineffective to reduce external vulnerability and have high costs;
    - With *de facto* high capital mobility adjustable pegs are difficult to defend;

### 3. Challenges for Latin America

- A **float** allows an easier adjustment of the real exchange rate in the face of shocks;
- It may also reduce the volatility of short term flows;
- And it allows the effective use of monetary policy to accommodate real shocks;
- To work properly a **hard-peg** requires conditions (that countries like Hong Kong meet) which are difficult to achieve for an emerging market economy;



# 3. Challenges for Latin America

- In sum:
  - A floating exchange rate along with inflation targeting and an open capital account seems a good mix (Chile);
  - But a float requires a **credible** nominal anchor, either a monetary or an inflation target, for which a highly reputable Central Bank and the absence of fiscal dominance is needed;
  - In the fiscal front a counter-cyclical but, at the same time, sustainable policy, like Chile's 1% structural surplus rule, ensures fiscal solvency (which can also reduce country risk and capital flow volatility).

### 3. Challenges for Latin America

- Bottom line: the macro policy mix must be internally consistent and robust to different scenarios (policies have to function well in good and bad times).
- But beyond macro stability there are also many challenges:
  - In trade: more progress is needed in opening up and in improving access of the region's exports to developed countries' markets.
    - Given the difficulties arising in WTO meetings, an alternative is to sign FTAs with important economies (like Chile and Mexico have done).

### 3. Challenges for Latin America

- In the financial sector: improve and/or update prudential supervision and regulation in the financial system, specially banks, enhancing market discipline.
- Further, much progress is needed regarding:
  - Privatization of SOEs;
  - Tax reform;
  - Updating the regulatory framework affecting public utilities;
  - Liberalization and flexibility of labor markets.

### 3. Challenges for Latin America

- But Latin American countries have to go beyond and develop or strengthen institutions that:
  - Assure property rights protection;
  - Reduce the degree of corruption;
  - Increase the enforcement of contracts;
  - Make the judiciary system more efficient;
  - Reduce political interference with monetary, fiscal and exchange rate policies (like Chile's fiscal rule and recently introduced merit-based public servants career).

### 3. Challenges for Latin America

- This is a difficult task because most likely it involves confronting some of the society's interest groups.
- All the elements above (and others) are necessary to create an environment more supportive and conducive to investment and innovation.

### 3. Challenges for Latin America

- A final big challenge concerns income distribution.
  - Here the key innovation for improving income distribution will come from empowering the poor by giving them access to assets that will enable them to work their way out of poverty:
    - education to increase their human capital (coverage and quality);
    - titling reform to allow their micro enterprises to operate in the formal sector;
    - micro credit to allow them to buy physical capital.
  - Labor market flexibility also matters in this area.



