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Cyclical and Structural Challenges for Latin America

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I want to thank the organizers for inviting me. It is a great honor to be speaking at such a prestigious business school. This is my first time in Durham, and I hope it will not be the last.

I very much enjoy attending this conference because I see it as a great chance to debate about business opportunities in Latin America. I say this because it takes place at a time of fundamental changes in the world economy with a first-order impact for the region.

First of all, and needless to say, we are in the middle of a financial and fiscal crisis in many countries, whose resolution is not easy and which has many implications for emerging markets. The relative attractiveness of Latin American countries in a context of economic stagnation in many parts of the world is not easy to deal with. I call it the *cyclical* challenge.

But also, we are in the midst of a tectonic change in the world economy, with developing countries taking a more central role in it. This is a great opportunity for the region, but full of dangers, too. As the Financial Times put it in an editorial some months ago, the largest danger for Latin American countries is complacency. I call this the *structural* challenge.

This is why I think this conference is so timely, and these are the issues I want to talk about today. Issues that I believe are highly relevant for the business community interested in Latin America.

In 2003, economists Carmen Reinhart, Ken Rogoff and Miguel Savastano published a paper entitled "Debt Intolerance". The paper presented an assessment of the level of external-debt-to-GDP ratios that was safe or tolerable. They linked the debt threshold to the current observable economic fundamentals as well as to the historical behavior of countries, arguing that a bad record significantly increased the probability of defaulting.

They found that the level of foreign debt economies could tolerate was quite low, and that many Latin American countries had external debt positions that were too weak. Their conclusion was that a significant part of the region was facing a huge *de-leveraging* challenge.

They also presented some evidence on how countries have dealt with these de-leveraging challenges in the past, both in Latin America and elsewhere. Their inference was clear:

"For debt-intolerant countries, sustaining access to capital markets can be problematic unless debt ratios are quickly brought down to safer levels. To assess how such 'de-leveraging' might be accomplished, we examine how, historically, emerging market economies with substantial external debts have managed to work them down. To our knowledge, this is a phenomenon that has previously received very little, if any, attention. We analyze episodes of large debt reversals, where countries' external debt fell by more than 25 percentage points of GNP over a three-year period. Of twenty-two such reversals that we identify for a broad group of middle-income countries since 1970, almost two-thirds involved some form of default or restructuring. Only in one case—Swaziland in 1985—was a country able to bring down a high ratio of external debt to GNP solely as a result of rapid output growth."

To some extent, the mood in the early 2000s was that, unless something extraordinary happened, many Latin American countries would face a non trivial probability of defaulting, as the possibility of running persistently high current account surpluses in a relatively short period was limited. And the experience of the Latin American debt crisis of the 1980s was so dramatic that, paraphrasing Mao's description of the Cultural Revolution, this was not supposed to be a dinner party.

Interestingly, the decade shows that no default happened—Argentina aside—, and that countries were able to lower their net foreign debt positions without having to make difficult adjustments in expenditures.

Some data come in handy here. During the first decade of the twenty-first century, Latin American countries managed to lower their net foreign debt by about 20% of GDP. The current account balance, which had shown a perennial deficit during the 1980s and 1990s, posted an average surplus during the 2000s of around 2% of GDP. Similar figures arise when we analyze fiscal balances. Finally, while stable during the 1990s, the real exchange rate of Latin American countries vis-à-vis the rest of the world appreciated about 20% over the last decade.

What happened, then? What explains this surprising outcome? I want to argue—as many others have—that this was a combination of good luck and good policies. Good luck because the region faced a period of extraordinarily high commodity prices and high terms of trade, which raised income significantly.

But good policies too because, on the fiscal front, governments made an effort to save a significant part of the terms-of-trade gains, in contrast to many other previous booms. And on the monetary policy front, Central Banks followed sound policies and allowed for exchange rate flexibility, while governments developed a more prudentially regulated financial system that prevented an excessive expansion of credit.

Why do I take this *detour*? Because the experience of some Latin American countries in the last decade sheds light on both the cyclical and the structural challenges we face today. The financial crisis has revealed a huge de-leveraging challenge for developed countries. The cyclical position of the world economy is dominated by the need of households and governments in the United States and Europe to lower their debt burdens. In contrast with the Latin American experience, this process will not be alleviated with a terms-of-trade windfall for the developed world. This has significant macroeconomic implications for the region.

Also, beyond these cyclical considerations, world activity is shifting towards countries with a greater share in demand for commodities and natural resources. This structural change is good news for Latin American economies, but it represents a monumental challenge, both economically and institutionally.

Let me get into these issues in more detail.

## Cyclical Challenges

The financial crisis revealed a significant debt burden in developed countries. In the United States, household indebtedness soared in the last couple of decades, to a large extent financed by highly-leveraged financial intermediaries. In Europe, government debt increased substantially prior to the crisis and very large fiscal stimulus packages as well as rescue packages to financial intermediaries have made the fiscal situation in some countries unsustainable, or intolerable.

This is not the moment to discuss the causes of such leverage, whether there was a bubble in assets prices, overly high expectations of future productivity growth, low interest rates or low risk premia. The fact of the matter is that the change in the conditions which sustained those high debt levels triggered a jump in debt/equity ratios of households, banks and governments to unsustainable levels. This needs to be significantly adjusted.

Policies to mitigate the costs of de-levering for some private agents or private institutions have made some governments absorb the debt burden by simply transferring the challenge of de-leveraging from the private sector to the public sector.

Where is the need for de-leveraging more urgent? Market prices give us a hint. In the United States, the costs of households' debt, either in mortgages or consumer credit, reflects the market's perception that households' balance sheets are very weak. The financial sector also has been subject to similar pressures, although very significant liquidity provisions by the Federal Reserve have helped smooth this process.

In Europe, meanwhile, the fiscal situation is very delicate. The sharp jump in credit spreads in public bonds in these countries reflects the markets' concerns not only about the sustainability of their fiscal positions but also regarding their ability to do this de-leveraging process without restructuring their debts. Banks are also under severe stress.

But unlike Latin American countries in the 2000s, the U.S. and European countries are not going to enjoy a terms-of-trade boom that will allow lowering their net debt positions without a significant drop in domestic expenditures. Therefore, this is probably going to be a painful de-leveraging. A period of prolonged low consumption and investment growth, and fiscal adjustments is very likely. Also, a Real Exchange Rate (RER) depreciation – which is equivalent to a fall in real wages – is needed. We have seen some depreciation in the US dollar, and to a much lesser extent in the Euro. But the heterogeneity within the Euro and the inability of some European economies to generate a sharp fall in the value of their currencies is pushing them toward a contraction. At this stage, the common currency in Europe has become a problem, and a relevant one.

The financing programs for Greece and Ireland, and maybe others to come, reflect the perception that governments and banks' balance sheets are deadly hurt, and that creditors must bear part of the burden. A significant part of this process results from the assistance that governments have provided financial institutions. Back to the "debt intolerance" debate, the market seems to be internalizing the idea improving their net asset positions would require a significant adjustment in expenditures and activity—which is highly difficult—as well as some form of default.

Evidently, all this is not good news for Latin America. After years of sustained world growth, we are in front of a sluggish recovery in the rich countries that will affect the dynamism of the rest of the world. Of course, this is not to say that the correction of the unsustainable growth and consumption path in the developed world is not welcomed, but their debt crisis reveals that it will probably take some years for us to see a highly dynamic world again.

Up to now, there is some sort of decoupling in the world economy. Growth rates are high in many countries, including Latin American ones, and the relative attractiveness of these economies has increased significantly. Assets prices and capital flows are proof of that.

There are reasons to think that it is difficult to sustain a decoupling in growth beyond the short term in a context of such weakness in the rich economies. The weakened world demand could put a limit on the speed of recovery beyond 2011 unless significant reforms and supply-side policies are put in place. But at the same time, the fundamentals for a strong recovery in the region after the crisis are clear: strong balance sheets, room for consumption and investment recoveries after a significant adjustment in 2008 and 2009, capital inflows, and sound banks. All of this is supportive of strong growth rates.

Also, there are signs of overheating in some countries. China is a good example and, to some extent, Brazil is, too. Growth during the crisis was strongly supported by a tremendous fiscal and credit expansion, which boosted public investment and inventory accumulation in the industrial sector. These countercyclical policies need to be retracted, and incipient inflationary pressures reflect exactly this phenomenon. Demand-side pressures and inflation are further enhanced by the inability to allow for nominal exchange rate adjustments.

High differential growth rates, differences in monetary policies are generating large capital inflows to emerging markets, increases in asset prices and pressures on exchange rate appreciation. Some thoughts on this process.

a) We have been here before, and many parts of the world have been here before, too. The Latin American debt crisis in the early 1980s and the Asian crisis in the 1990s reveal the challenge that capital inflows pose to countries. In these cases, (and keeping in mind many differences among them), the period previous to the crisis was characterized by excessive government expenditures, rigid exchange rate regimes, and weak financial intermediation. All this contributed to high debt, difficulties in relative price adjustments and excessive risk taking. When conditions changed, the adjustment was extremely painful.

b) As long as this cyclical process is very short lived, then the strategy of broad interventions in foreign exchange markets and imposition of capital controls could be justified. But if this cyclical process has more life in it, the fight against nominal exchange rate appreciation encourages capital inflows and increases inflation. Judging by the magnitude of the adjustment required in the developed countries, and by the need for fiscal consolidation, I think it is in the interest of developing countries to allow their currencies to appreciate. Otherwise, the pressures on financial intermediation could have significant implications for financial stability in the medium term. This is specially the case now that some economies are showing signs of unsustainable growth and inflation.

c) This leads us to the famous (or infamous) discussion on global imbalances and currency wars reflect these tensions. The natural implication of growth differentials and monetary policy differentials is a change in relative prices which lowers the relative price of non-tradable goods in the developed world. This requires, among other things, fluctuations in exchange rates which reflect the relative strength of domestic demand in surplus countries.

d) For those rich economies requiring debt adjustments, these changes are highly attractive. The fall in the real value of their currencies will help lowering real wages and eventually limit the output costs of domestic de-leveraging. It is a way of searching for an increase in foreign demand to alleviate the impact of the fall in domestic demand. The need for re-balancing world demand toward surplus countries requires a fall in the value of the currencies of deficit countries and the opposite trend in surplus economies.

e) For developing countries, whose currencies are supposed to appreciate, this process is not that easy, as it is seen as a challenge to the export-led policies followed for many years. Exchange rate appreciations in developing countries are a necessary but not sufficient condition for this shift in world demand to take place. There are many other reasons why saving rates are high in these countries, and the shortage of well developed financial intermediaries limits the ability of running current account deficits without seriously jeopardizing financial stability in the medium term. Therefore, it is unlikely that this rebalancing of world demand will spur global growth sufficiently to avoid a period of slower growth.

I believe the relative attractiveness of Latin America plays a significant role in the new cyclical position of the world economy. The implications for macroeconomic management should be derived from previous experiences: fiscal conservatism, prudence of financial intermediaries, flexible exchange rates and price stability are the main recipes to avoid a destabilizing growth cycle.

This is more important given the highly uncertain prospects for the world economy in the short run. In the last weeks we have seen a very significant run against government and financial debt in some European countries. And as we speak, this stress is not decreasing. In my opinion, this reaffirms that the debt burden that many countries and institutions have is big. And it also suggests that the expectations of a never-ending decoupling in the world economy could be too optimistic.

We should be aware of the risks that the current situation poses to the region. A scenario where the weakness of the rich economies does not significantly contaminate the recovery in the developing world is the most likely one. But the possibility that the stress in the European financial sector broadens, with larger effects on the world economy, cannot be dismissed.

Structural Challenges:

Beyond the challenges that the world economic cycle poses to Latin America, a new reality has come up: the emerging world has become increasingly relevant, and hence the demand for commodities and natural-resource-intensive products will probably stay high for some years. As we mentioned before, this explains the costless de-leveraging in the region in the 2000s, and this phenomenon is probably here to stay. In my opinion, the relative strength that the developing world has gained constitutes a tectonic movement in the world economy.

This is good news for the region, as it modifies substantially a fundamental flaw. For decades, the lack of domestic savings and the intermittent access to world capital markets limited the ability to introduce reforms and develop projects—presumably with high social returns—in the region. To some extent, the financial restriction was the main restriction for growth. This new reality suggests that this is not the case anymore.

Of course, there have been periods of broad access to world capital markets. And, as we already discussed, these periods have been highly challenging for the region, and in general the outcome has not been the best. Historically, periods of high terms of trade have promoted excessive spending, the relaxation of fiscal responsibility and the expansion of credit without proper risk assessments. Although the behavior of the region has been encouraging this decade, I am not sure the lesson is fully understood. This is what some people call the "this time is different" syndrome.

But I am referring here to a more persistent relaxation of the financial restrictions. I am referring to a process in which financing constraints are not binding anymore. To some extent they are always binding; but you know what I mean. The institutional developments needed to allow this windfall not to become a curse are highly complex. The economic and political institutions are in many cases weak, and the speed of reform in these dimensions in necessarily slow; definitely much slower than the needs and demands of the population.

This is exactly where the space for reforms arises. Running the risk of oversimplifying the analysis, I just want to mention two reforms that I think are crucial for the region: an educational reform and a labor market reform. Let me explain why these are crucial and how they are related.

One of the fundamental weaknesses of Latin America is its low productivity. Part of it is probably embedded in labor; firms produce little per unit of factor. But another part is probably related to an inadequate allocation of factors; which reflects labor and financial market frictions.

During the longest part of the *XXth* century, low productivity lead to low output, which was evenly distributed across factors due to lack of international factor mobility. In other words, both labor and capital were slaves of a low productivity environment.

Globalization, mainly financial globalization, has opened up the room for capital (both physical and human) mobility across borders. In other words, it has released some – but not all - factors from the low-productivity trap.

This process is welfare enhancing, but it is highly unequal. This is because the burden of a low productivity environment is mainly faced by those factors that cannot escape the trap. The return to capital and wages of high-skilled workers are set in world markets, while the return to immobile factors (land and low-skilled labor) is set domestically. In a context of increase in the relative prices in resource-intensive products, the pressures on low-skilled wages in even higher.

This is the main tension that globalization carries for developing countries. And this is why it is politically so contested. This should not be seen as a problem of globalization. The integration of world factor markets just reveals our weakness, which is a huge mass of uneducated people in a context of low productivity.

Interestingly, the very same reasons that make low productivity affect so intensively low-skilled workers makes policies enhancing productivity so attractive to those very same workers. The majority of the costs of bad policies are faced by low-educated workers; the majority of the gains derived from good policies are enjoyed by low-educated people.

This is exactly why the new reality could make Latin American countries enjoy the full benefits of globalization. High commodity prices provide the resources to promote education reforms and to promote productivity through factor reallocation. These reforms require resources, they require the establishment of a safety net that protects workers but not jobs in order to make them fair and feasible, and finally they require significant institutional changes to avoid waste. This is probably the largest challenge of all.

Let me finish with a macroeconomic consideration. One of the implications of the increase in the relative price of natural resource intensive products is that the region could be entering a period of sustained pressures toward exchange rate appreciation, pushing the countries to specialization in natural resources.

Many countries don't like this. And they promote capital controls and exchange rate interventions as means to combat this new reality. These are not effective mechanisms to confront these challenges. The debate should be the other way around; how do we make the best out of the abundance we are facing. Those who strengthen their political and economic institutions, promote good investment climates and provide their population with real and effective educational tools will be the ones who will truly profit from this.

We have the resources. I hope we have the will and the wisdom. It could take many decades for another opportunity like this to come our way. Thank you.