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Promoting Growth in Latin America

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PROMOTING GROWTH IN LATIN AMERICA

Presentation by Ms. Anne Krueger, First Deputy Managing Director of the International Monetary Fund at the Central Bank of Chile – World Bank Conference on Natural Resources and Growth, January 18, 2002

1. Introduction

It is a great pleasure to be in Santiago again. There could not be a better location for a conference on natural resources and growth. Chile – like many countries in Latin America – has had to contend with the “commodity lottery” for many decades. In recent years, Chile has also established for itself a well-deserved reputation as a leader among emerging economies in the design and adaptation of sensible economic policies, which has enhanced the use of these resources as a basis for growth. The results speak for themselves: strong growth through much of the 1990s, and resilience in the face of the current difficult external environment. This suggests that, while natural resources present challenges, they also can –with good economic management– become an opportunity by providing the income to finance investments in a country’s true vital resource – its human capital – and in the physical capital that makes people more productive.

For this presentation, I will leave the topic of natural resources aside and focus briefly instead on two issues that have an important bearing on Chile’s growth prospects, in particular, and for Latin America more broadly. The first topic is the external environment, specifically the world economy and its prospects for the coming year. The second topic reforms to the progress of economic reform in the region. I believe both topics give us cause for cautious optimism, but no complacency.

2. The World Economy

Let us analyze the world economy first. 2001 was a bleak year, with weak underlying economic activity exacerbated by the blow to confidence from the awful terrorist attacks on September 11. Global demand remains feeble now and – as ever when confidence plays a key role – both the timing and strength of the impending upturn are hard to predict.

There are some positive signs, though. Industrial production does appear to have bottomed out in some countries, and confidence, albeit at still depressed levels, seems to be stabilizing. Global financial markets have strengthened, with the “flight to quality” beginning to reverse, and equity markets recovering the losses they suffered after the September 11 shock.

Recovery should become more widespread and visible during the first half of this year. Such should be the effect of the prudent loosening of monetary policy sawn last year, the end of the inventory correction, and of lower energy prices. On the downside, current weaknesses in confidence, profits and investment could persist. And the smoothness with which global current account imbalances will unwind still remains to be seen.

Within the G7 countries, there are significant differences in the near-term outlook. We should see a rebound in the US by the middle of the year, as investment picks up and the inventory cycle turns. In Japan, growing risks of a deeper recession underline the need for structural reforms and supportive macroeconomic policies. Confidence in the Euro-area has shown signs of stabilizing, but recovery may lag behind the US. Overall, though, we do expect a reasonable growth through the year.

What does all this imply for Latin America? Economic growth has slowed sharply, from 4 percent in 2000 to nearer 1 percent last year. The external environment is, of course, largely to blame. In particular, weakness in the US has been transmitted to the region via subdued demand for exports, lower commodity prices, and a fall in the flows of foreign direct investment, as US companies have smaller profits to finance it with.

Fortunately, the default and devaluation in Argentina have so far had limited spillover effects on the region's financial markets, in part because they were already priced in by most investors, and also because capital flows were already very weak.

It is too soon to be sure of the broader economic spillover. Outside Mercosur, trade and financial links between Argentina and other countries in the region are relatively limited. But following the sharp slowdown in activity last year, growth across the region is bound to remain relatively subdued this year. Market confidence remains weak, and capital flows are therefore likely to remain volatile for a while. Under such circumstances, countries with large current account deficits and uncomfortably high burdens may be vulnerable to any deterioration in investor sentiment and renewed flight to quality. Overall, though, our attitude should be one of cautious optimism.

The situation in Argentina itself remains, of course, very difficult. We are in close touch with the authorities and ready to help with policy advice and technical assistance. The immediate priority for them is to develop a coherent and sustainable policy framework that safeguards the banking system, strengthens the fiscal position, puts a sustainable exchange rate regime in place, and restructures its debt.

3. The Progress of Economic Reform

Despite the fragility of the global economy and the difficulties faced by its eastern neighbor, Chile's economy has been impressively resilient. Weaker domestic and overseas demand and lower copper prices inevitably prompted some slowdown last year, but GDP growth still came in around 3 percent – one of the strongest rates in the region. Inflation meanwhile ended the year comfortably within its 2 to 4 percent target range.

This performance is a testament to prudent macroeconomic policies and ambitious structural reforms pursued over an extended period. This has helped to maintain investor confidence when most needed. As a result, neither the government, nor leading companies in Chile that have traditionally enjoyed access to international capital markets have had difficulty securing finance at a time of depressed capital flows for the rest of the region.

Chile's performance should encourage reform efforts in the rest of Latin America. Reform has had three welcome features:

- First, reform has been geographically extensive. Most countries have not done as much or as quickly as Chile, but almost all have at least embarked on the right path at some point, and are now heading in the same direction.

- Second, reform has been extensive in scope. Improvements have ranged from macroeconomic policy, through narrower technical fields (like regulation and education), to areas that used to be considered beyond the strict economic domain (including governance and judicial reform), but which are increasingly recognized as fundamental.

- And, third, reform has generally endured difficult circumstances and been sustained in time, with only a couple of countries deciding to backtrack. Moreover, adverse developments like the Mexican financial crisis in 1994-5 have generally prompted intensification and deepening of reform, rather than relaxation. We must hope that the same now becomes true for Argentina as it gets back on its feet.

Latin America is, of course, a very heterogeneous region. Countries that have made good progress in one area do not necessarily have made as good progress in an overall basis. Indeed, it is less easy to separate consistently "strong" and "weak" performers as it used to be. However, Chile is undoubtedly a strong performer, and its record shows that deepening and widening reform does deliver results.

Let me turn now to the three areas in which, in Latin America in general, and in Chile in particular, reform has made important progress: macroeconomic policy; market liberalization; and institutions and social policy.

First, **macroeconomic policy**. In all but a few Latin American economies, inflation is now in single digits. This is a major achievement, that few would have thought possible several decades ago. Most countries have strengthened their monetary management, increased the independence of their central banks, and moved towards the adoption of credible policy frameworks such as formal inflation targeting. Exchange rate regimes have also, and by large, moved in the welcome direction of greater flexibility.

There have been important advances in the fiscal area too, but progress here has been less well sustained. In the 1980s and early 1990s, many countries tightened fiscal management, reduced inefficient public subsidies, reformed bloated civil services, and overhauled tax systems. But by the late 1990s, many of the gains in terms of lower budget deficits had been reversed. This reflected the continued dependence of many tax systems on commodity prices, as outlays to pay for banking crises and increases in local government spending. Many governments are now attempting to address these problems through structural and institutional reform. It is important for them to continue.

Chile exemplifies the benefits of maintaining a strong underlying fiscal position. By doing so through the early 1990s, the authorities gave themselves scope to safely run a counter cyclical policy in 1998 and 1999, thereby helping to ensure that the recession following the Asian financial crisis was brief and shallow. Similarly, now, with a structural surplus equivalent to around 1- percent of GDP, the authorities can run a modest overall budget deficit appropriate to the economy's relative slowness and the low revenues from copper production. Thus, the goal is not fiscal conservatism for its own sake, but rather – to borrow a favorite phrase of Gordon Brown, the chairman of the International Monetary and Financial Committee – "prudence for a purpose".

Alongside stronger macroeconomic policies, **market liberalization** has been another important outcome of reform. And this too has had a number of dimensions.

First, widespread trade liberalization during the 1990s means that about half the countries in Latin America now operate a trade regime that is, at least, as open as that of the United States. Going further in this direction can only help underpin the long-term growth prospects of the region. Chile again has led by example, putting its external tariff on a long-term downward path, and now placing a high priority on securing an early free trade agreement with the United States.

Second, financial sector reform. One of the lessons we have all learned since the Asian crises is the importance of a well-functioning financial system for economic growth. When the financial system channels new savings into their most productive uses, growth can be robust and rapid. If, instead, banks lend into non-performing loans, society's resources are misallocated and potential growth is greatly reduced. This past decade, financial markets have been widely liberalized for both domestic and international transactions. Together with macroeconomic stabilization and other policies, this has contributed to significant financial deepening. However, firms in many Latin American countries still find themselves facing a credit shortage. Indeed, the supply of private credit as a share of GDP is only a third of that in the industrialized countries or Southeast Asia. Remaining frailties in domestic financial systems and capital markets are partly to blame. For example, and although prudential regulation has been much improved, protection for financial creditors is often inadequate and there is too much government interference in financial contracts.

Third, market liberalization has occurred as privatization has fostered big flows of foreign direct investment, especially in utilities and banking. Foreign banks, for example, moved from a negligible position at the beginning of the 1980s to holding over 40 percent of the region's banking assets in 2000. This has brought stability and expertise to the sector. Chile again was a pioneer, taking steps during the 1990s not only to deepen its privatization efforts, but also to emphasize transparency, competition and fair pricing in the process.

Finally, let me turn to institutions and social policy, where reform has generally been slower to get under way and where progress remains patchier.

Chile was quick to emphasize these areas during the 1990s, placing them at the heart of what we have come to call "second-and third-generation reforms". Institutional reform has increasingly been recognized as a way to enhance the impact of market liberalization. To that end, many governments in the region are now introducing measures to increase transparency and accountability, and to reduce corruption. In Chile, for example, wide-ranging reforms are being made to the judicial system.

On the social side, policymakers have been driven by goals of both efficiency and equity. They have recognized that investing in human capital – through education, health care and social safety nets – better equips the economy to produce more high-value knowledge and technology intensive goods. At the same time, it also helps address Latin America's high levels of poverty and income inequality. Social spending has risen as a share of GDP across the region, often with particular efforts to target the benefits upon the poorest segments of the population.

Using labor market reform to bear down on unemployment has similar benefits in terms of both efficiency and equity. Here, arguably, is an area in which Chile has not performed as well as it could, with unemployment remaining above 9 percent. It would be important that changes to the country's labor laws do not have the result of building more rigidity into the market.

4. Conclusion

Let me conclude by noting once again that much has been done over the past decade or more to strengthen macroeconomic and structural policies in Latin America as a whole. We have seen the benefits in a return to per capita GDP growth after the "lost decade" of the 1980s. But this needs to be put into perspective: real incomes have grown less quickly than in the industrialized and many Asian economies, and there are still around 170 million people in the region living on less that $ 2 a day.

Chile has reformed more vigorously and more extensively than most other Latin American economies. And it has grown more strongly, and reduced poverty more sharply. It is hard to believe that this is a coincidence. It is also hard to believe that other countries in the region cannot emulate its example and that Chile itself cannot do even better and further narrow the gap with the industrialized world. As the global economy moves out its current slowdown, the opportunity is there to be seized.