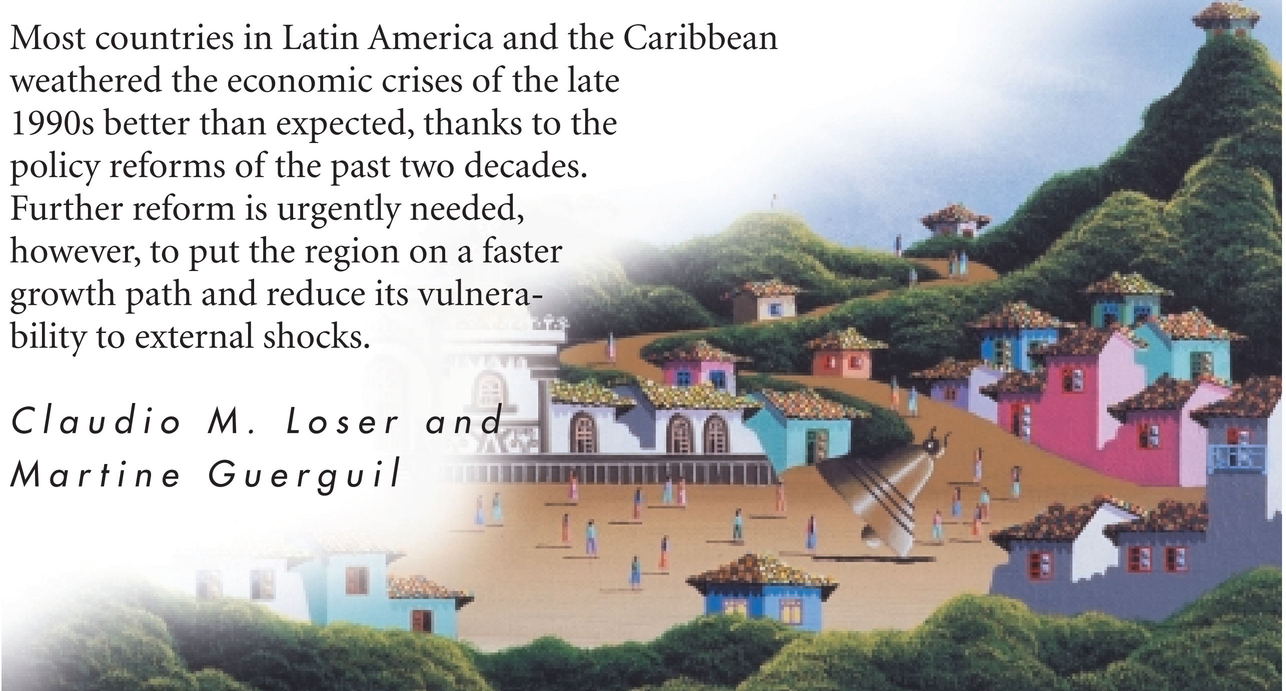
The Long Road to Financial Stability

Most countries in Latin America and the Caribbean weathered 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.

Claudio M. Loser and Martine Guerguil



THE PAST few years have been difficult for Latin America and the Caribbean. The turmoil that swept through international capital markets in 1997 and 1998, combined with the region's deteriorating terms of trade and declining export earnings, produced an economic slowdown that boosted unemployment levels and depressed incomes. The downturn, the second in five years and the largest and broadest since the debt crisis of the 1980s, was a disappointment for a region that had been following a strenuous path of policy adjustment and reform for more than a decade. Per capita output in Latin America and the Caribbean was only 13 percent higher in 1999 than in 1989, and only 7 percent higher than in 1980. Nonetheless, in the face of an extremely adverse external environment, economies in the region displayed unexpected signs of strength, in large part because of the reforms they had undertaken earlier. Private investment proved resilient, and there are signs that output is already beginning to recover after a slowdown of relatively short duration.

Reforms of 1980s and 1990s

After the debt crisis, economic policy in Latin America and the Caribbean underwent a dramatic change. Plagued with severe distortions in the use of resources, most countries abandoned the old model of state-directed, import-substituting industrialization in favor of outward-looking, market-based policies.

In the late 1980s, the fight against inflation—and, more generally, the pursuit of financial stability—became the leading policy objective of many governments around the world, including those in Latin America and the Caribbean, which moved toward stricter fiscal management, reducing government expenditure, reforming bloated civil services, and overhauling tax systems. As a result, 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, greater 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.

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 (see box).

• *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. A number of publicly controlled financial institutions were also sold to private interests. In most cases, privatization led to a sharp increase in private investment. Privatization did not progress equally rapidly in all countries, however; the process lagged significantly in some countries and was hampered by a lack of transparency in others; in most, the large mining and oil companies remained in the hands of the state.

Economic benefits of reforms

In the early 1980s, when the region found itself engulfed in a string of acute financial crises, it suffered a prolonged short-

Regional trade agreements in Latin America and the Caribbean

The 1990s witnessed a surge in trade agreements in Latin America and the Caribbean: studies by the Inter-American Development Bank show that more than 20 agreements were signed and, at the end of the decade, another dozen were at different stages of negotiation. Panama is the only country in the region that is not a member of any trade agreement. Some agreements are bilateral, others subregional; they range from simple free trade accords to more comprehensive agreements that resemble NAFTA (the North American Free Trade Agreement) or even customs unions that have the explicit objective of creating a common market or community.

Paralleling these initiatives, intraregional exports grew 19 percent a year during 1991–97, compared with 8 percent for exports to countries outside the region, and accounted for 20 percent of the region's total exports. Trade between the Mercosur countries (Argentina, Brazil, Paraguay, and Uruguay) rose fivefold, to account for one-fourth of total exports. However, the recent financial turmoil, depressed commodity prices, and regional economic slowdown have hurt Latin America and the Caribbean's trade performance, with intraregional trade suffering disproportionately. Although the region's total exports are expected to increase slightly in 1999, intraregional exports could fall by 25 percent or more.

Integration is not a new phenomenon in Latin America and the Caribbean. A number of ambitious initiatives were launched in the 1960s and 1970s: the Latin American Free Trade Association, the Central American Common Market, the Andean Group, and the Caribbean Community. But the policy framework and the objectives have changed.

Earlier attempts at regional integration emerged in the context of the import-substitution strategy that prevailed in the region for several decades. Seen as a way to compensate for the small size of domestic markets, regional integration was inward-looking and based on highly protected domestic markets coupled with strong state intervention. In this context, trade liberalization was undermined by, among other things, national commitments to protection, chronic balance of payments problems, and generally poor macroeconomic policies. Negotiations proved laborious and quickly stalled. All the regional initiatives lost steam in the 1970s and entered into crisis in the 1980s.

In contrast, the regional integration of the 1990s is taking place within a policy regime focused on comprehensive structural reforms designed to make the economies more market-based and open to the global economy. It is part of a wider trade liberalization strategy that began in the late 1980s with unilateral opening and the reduction of the region's average external tariff from over 40 percent to about 14 percent by the late 1990s. At the multilateral level, the region has bound 100 percent of its tariffs under the Uruguay Round (although at rates well above applied tariffs) and made a commitment to open markets under the World Trade Organization. Although regional agreements allow

age of foreign financing and a severe and protracted slump in output (see chart). Although the reforms that took place after these crises could not insulate the region from the global financial crisis that began in Asia in 1997, they limited the damage. Countries were able to control financial panic, preserve macroeconomic stability, and maintain some access to foreign financing.

The avoidance of financial collapse was a major achievement. Currency crises were quickly resolved (except in Ecuador) after short periods of turbulence. Although the share of nonperforming assets in banks' portfolios increased in most countries and some local banks came under stress, there were few systemic banking crises (except in Ecuador, Paraguay, and, to some extent, Jamaica) because the authorities were, in most cases, able to address banking problems promptly. Average regional inflation, which had dropped from nearly 1,000 percent at the end of 1990 to about 10 percent by the end of 1998, continued to decline, reaching 9½ percent by the end of 1999, its lowest level in about 50 years. Only Ecuador, Suriname, and Venezuela still have inflation rates over 15 percent.

Several factors contributed to the resilience of the Latin American and Caribbean economies. Prominent among them are the speed and determination of the authorities' policy response to the financial turmoil of the 1990s. Strikingly, most policymakers resisted calls to close off their economies or return to administrative management. This response was possible because the reforms had strengthened economic institutions and increased the efficiency and flexibility of domestic markets. For instance, upgraded banking prudential rules enabled most domestic banks to weather currency devaluations and monetary tightening. Resolute stabilization and other reforms may have helped to change public expectations, limiting the inflationary impact of currency devaluations.

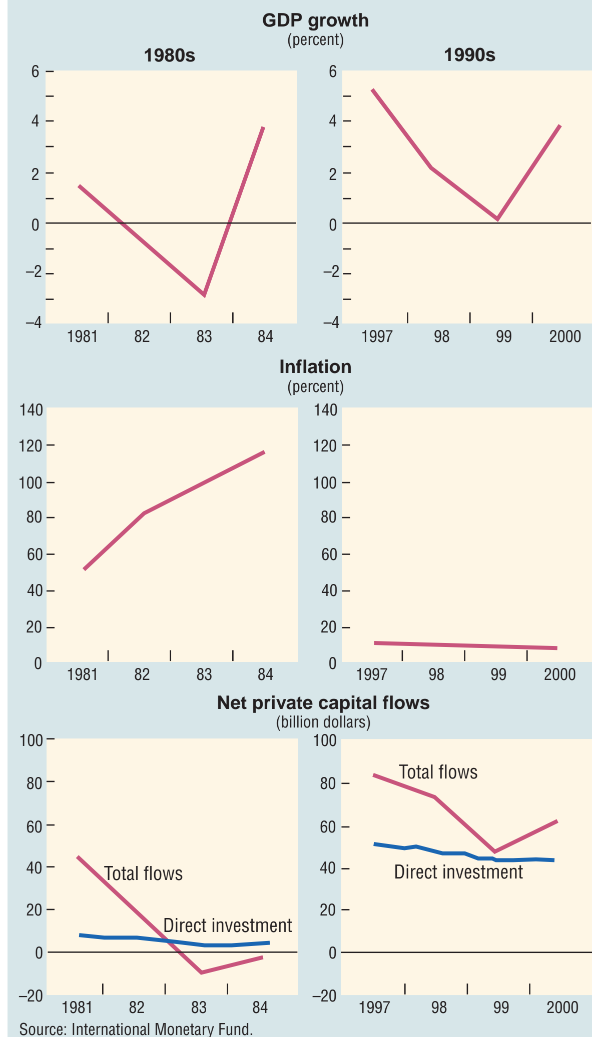
The decline in foreign financing flows to Latin America and the Caribbean in the late 1990s, although significant, was less dramatic than the decline experienced during the debt crisis of the 1980s, when capital rapidly began flowing out of the region; flows remained negative for most of the 1980s, and external obligations had to be renegotiated several times. In contrast, private capital inflows to the region, which had surged from $14 billion in 1990 to a record $86 billion in 1997 (4½ percent of GDP), contracted to $47 billion in 1999 but did not turn negative. In large part, this resilience was due to the high share of foreign direct investment, a less volatile form of financing—about 50 percent of total net private capital inflows during 1990–97, compared with 20 percent before the debt crisis. Net flows of foreign direct investment to Latin

countries to have preferred trading partners, they have lowered average protection beyond what had been achieved at the unilateral and multilateral levels. Generally, tariffs are to be eliminated on the bulk of intraregional trade within 10 years, with exceptions rarely exceeding 6 percent of tariff lines. Until 1998, this strategy fostered the growth of imports at an annual rate of 18 percent.

The objectives of regional agreements go beyond trade liberalization. First, they include export diversification. Manufactured goods account for roughly two-thirds of intraregional exports, which is considerably higher than their share of extraregional trade. Second, regional integration is seen as a tool for competing globally and attracting foreign investment (and the technology, know-how, and market access that often come with foreign direct investment). Third, regional commitments are assumed to have "lock-in" effects—that is, they are seen as harder to reverse than unilateral reforms. By focusing on reciprocal liberalization among like-minded countries, the new agreements allow the economic authorities to "signal" to the private sector their commitment to liberalizing reforms, even when unilateral or multilateral liberalization is not possible in the near term.

Serious critiques have emerged against the new regionalism. There is concern that it is leading to trade diversion (although the risks are lower when the economies are also opening up unilaterally). The proliferation of agreements may create a multiplicity of norms and regulations in the region, reducing transparency and raising transaction costs. More generally, it may threaten the multilateral trading system. Restrictive rules of origin in free trade areas as well as significant sectoral selectivity in the phasing-out of tariffs and preferences may offset the liberalizing effect of tariff elimination.

Empirical studies of the impact of regional agreements have yielded ambiguous results. Overall, regional integration may have been a useful component of structural reform and a complement to unilateral and multilateral trade liberalization. However, the recent financial crisis and associated economic slowdown have brought new challenges for regional integration schemes. Although the region has not restored the highly restrictive trade practices of the past, some countries have raised tariffs in the face of growing trade imbalances and weakening tax revenues. Local trade frictions have been growing, particularly within Mercosur, and the use of antidumping regulations and other administrative measures is increasing. Such measures threaten to undermine one of the key benefits of regional integration: stable and predictable market access. To benefit fully from the regional initiatives, the countries of Latin America and the Caribbean will need to sustain a commitment to openness, ensure that regional trade agreements enhance longer-term welfare gains, and discipline the use of nontariff impediments to trade through the development of transparent, rules-based safeguard clauses and formal dispute-settlement mechanisms.



America and the Caribbean rose from $7 billion in 1990 to a record $51 billion in 1997. They then declined by less than a fifth, to an estimated $43 billion in 1999.

Countries in the region also maintained access to other sources of foreign finance, although at a higher cost and in smaller quantities. The volume of international bond issues, for instance, was one-third lower in 1998–99 than in 1997, and spreads were twice as high, but bonds were still a significant source of finance (about $40 billion in both 1998 and 1999, equivalent to 60 percent of the external current account deficit).

Last, the reforms appear to have contributed to increases in labor and capital productivity, which, in turn, stimulated output growth. Average annual output growth was 3 percent in the 1990s, up from 2 percent in the 1980s. The rate of growth of domestic investment accelerated to 5 percent, from –1 percent, over the same period. Export volumes grew much faster in the 1990s than in the 1980s (9 percent a year, compared with 4 percent) and also grew faster than the overall volume of world trade. Empirical studies have concluded that the reforms raised the growth rate of total factor productivity by about 1½ percentage points, boosting the region's potential output growth rate to more than 5 percent a year.

Although the reforms did not prevent an economic slowdown in the aftermath of the global financial crisis, there are indications that it will be shorter and shallower than initially expected. The most visible illustration of this is Brazil, whose prospects for 1999 have been revised upward several times and whose economy is expected to recover strongly in 2000—like the quick recovery of Mexico's economy after the Tequila crisis of 1994. Regional output is estimated to have remained virtually flat in 1999, and a robust recovery is expected in 2000. This is less dramatic than in 1982 and 1983, when the economies of Latin America and the Caribbean contracted by 0.8 percent and 2½ percent, respectively. Out of a total of 32 countries, only 9 are expected to register a decline in output in 1999, compared with 17 in 1982 and 1983. By increasing the flexibility of the economies in the region, the reforms appear to have enhanced their capacity to adapt to shocks; the maintenance of sound financial policies and of open markets and continued strong foreign direct investment flows were also instrumental in limiting output volatility.

Remaining weaknesses

Although Latin America and the Caribbean coped better with financial turmoil than expected, the recurrence of external shocks and country-specific crises demonstrate that weaknesses remain and that further reforms are needed. The persistence of poverty and income inequality, for example, and their negative impact on the region's economic performance present the region with a daunting challenge (see "Poverty Reduction" by Nora Lustig and Omar Arias in this issue).

External vulnerability. Because of 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 impact of these global developments on Latin America and the Caribbean was only partly mitigated by the higher share of foreign direct investment in total finance. The region's dependence on foreign financing has led at times to an unsustainable buildup of domestic demand, a widening of the external current account deficit, and large fluctuations in the real exchange rate. The strong correlation in the movements of foreign financing costs across countries illustrates the extent of financial contagion in the region.

The economies of Latin America and the Caribbean, richly endowed with natural resources, have also remained vulnerable to fluctuations in export prices because their exports tend to be concentrated in commodities or semicommodities. In the 1990s, export receipts grew more slowly than both export and import volumes. As their terms of

trade became less favorable, countries in Latin America and the Caribbean saw their export earnings drop in 1998, to recover only modestly in 1999, despite a slowdown in domestic demand and frequent currency depreciations.

The region's growing integration into 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. Exchange rate bands proved vulnerable to speculative attacks and had to be abandoned, but the fixed exchange rate regimes of Argentina, El Salvador, Panama, and most Caribbean countries were successful and endured.

Fiscal fragility. The recent crises highlighted the importance of prudent fiscal policy for financial stability. This is not really a novel idea: as mentioned above, fiscal consolidation was a critical element of stabilization policies in the region in the 1990s. 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.

Recent developments suggest that the role of fiscal policy in today's world of increased financial integration and capital mobility may be more important than ever. This is because, in the globalized economy, market anxieties can spread quickly from one country to another, exposing underlying weaknesses and inconsistencies, and weak policies have more abrupt and pronounced consequences than in the past. This is particularly true of fiscal policy, because it is a very visible component of the authorities' policy stance and indicates the sacrifices they are willing and able to make to maintain financial stability.

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.

• First, notwithstanding extensive tax reforms, tax yields are low in most countries relative to tax rates because of widespread evasion and exemptions. Also, despite civil service reforms, public administrations remain unduly large; budgetary processes and institutions are often unstructured and underdeveloped; and expenditures are not focused on priority areas such as education, health, and infrastructure.

• Second, although the correlation between fiscal revenue and commodity prices is declining, it is still strong in many countries in the region, and foreign-currency obligations still account for a large share of public debt. This has continued to give a procyclical bent to fiscal policy: public revenues, spending, and borrowing capacity rise during commodity booms and fall during downswings, exacerbating the impact of external cycles on the economy.

• Finally, subnational governments contribute to the widening of the fiscal deficit, in part because of unrestricted revenue-sharing schemes, the ambiguous assignment of expenditure responsibilities among the various levels of government, and the absence of effective limits on the borrowing ability of subnational governments.

Weak institutions. The contribution of efficient public institutions and regulations to economic growth and welfare, although long recognized, acquired even greater prominence during the recent crises, particularly with regard to the availability of comprehensive and timely financial information, the accountability and transparency of government operations, and the stability of the regulatory and judicial systems. The region's progress in these areas has been relatively modest. 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 policy agenda

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. In many countries, there is still ample scope to strengthen public finances by revamping the tax system and reducing or eliminating inefficient public expenditure. To mitigate the impact of terms of trade fluctuations on fiscal revenues, governments may establish commodity stabilization funds such as those in place in Chile, Venezuela, and, most recently, Mexico. Finally, there is a need to impose hard budget constraints on subnational governments, public enterprises, and public financial institutions. More particularly, public debt management practices should be reviewed with a view to increasing the robustness of the public debt structure to external shocks.

Claudio M. Loser is Director of the IMF's Western Hemisphere Department.

Martine Guerguil is a Senior Economist in the IMF's Western Hemisphere Department.

Fiscal policy is, of course, not the sole instrument for reducing the region's external vulnerability; 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. Mechanisms to involve the private sector in the resolution of potential crises should also be explored. Nonetheless, both the new role of fiscal policy as a signal for the overall policy stance and the still significant scope for improvement in this area give a certain urgency to the strengthening of public finances in most of the region.

Governance is as crucial as it is complex and multifaceted, because it permeates nearly all aspects of economic performance. Governments in the region must strive to provide comprehensive, timely economic information and to meet international standards of transparency. With respect to financial regulation, they must avoid complacency and address remaining fragilities promptly (see "Banking Supervision" by Robert Rennhack in this issue). In the nonfinancial area, there is a need for simpler, more transparent regulatory systems that are equitably enforced. More results-oriented, transparent, and accountable governments are also needed at both the national and the subnational levels, and corporate governance must be strengthened.

Rocked by several successive waves of financial turbulence over the past few years, countries in Latin America and the Caribbean have shown great resilience. The task of reform is far from complete, however. To accelerate growth and improve social welfare, the region must maintain its reform momentum. Only then will it be able to combine its long-term ideal of sustained growth with democracy and social equity. F&D

Meet the man who's always there
in a [financial] crisis

Stanley Fischer
first deputy managing director of the IMF

in *The Region*
the quarterly magazine of the
Federal Reserve Bank of Minneapolis

on the Web
minneapolisfed.org/fischer.html

Fischer responds to criticism leveled at the IMF
and shares his thoughts on emerging economies,
currency boards and other issues in the world
economy with which he is so familiar.