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Chapter VI

POLICY REFORMS AND ECONOMIC PERFORMANCE: THE LATIN AMERICAN EXPERIENCE



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A. Introduction

The Latin American region was considered to have extremely high development potential when it broke from colonial dominance, because of its rich natural resource endowments as well as traditions and institutions brought from Europe. By the beginning of the First World War, per capita income in Argentina, the most advanced Latin American country, exceeded that of France, Germany, Italy and Spain. Per capita GDP for the region as a whole exceeded that of Japan, and was around three times the average for the rest of East Asia. The picture had not changed much by 1950; indeed, the gap with East Asia had grown wider. However, as noted in chapter IV, after almost two decades of rapid growth, the economic performance of the region started to deteriorate in the 1970s. By the end of the 1990s, incomes in East Asia were, on average, roughly twice as high as those in Latin America.

This persistent and rapid deterioration in Latin America's position relative to both the industrialized countries and the successful develop-

ing economies of East Asia raised doubts about the appropriateness of the economic policies adopted in the region. It led to widespread scepticism concerning the ability of those policies to capitalize on the region's natural wealth in order to raise living standards for the population, let alone achieve progress towards convergence with the per capita income levels of developed countries. While the 1980s have been called the "lost decade" in Latin America, economic performance was also unsatisfactory in the 1990s, as the discussions in the previous chapters amply demonstrate. With a few exceptions, countries in the region have been unable to remove structural and institutional impediments to rapid and sustained accumulation, growth and structural change, despite drastic changes to their development strategy introduced in response to the debt crisis of the 1980s. Reforms, including replacing policies of "development from within" with a greater emphasis on outward-oriented growth, failed to replicate the successful growth and industrialization of East Asia. Rather, the new policy orientation

created new dilemmas without resolving the old ones; in particular, the region remained unable to fully exploit its export potential and therefore continued to depend on foreign capital inflows. This led to the reappearance of balance-of-payments and debt problems similar to those that had contributed to the debt crisis in the first place.

Since the introduction of policy reforms in the 1980s, most countries in the region have undoubtedly made significant progress on the macroeconomic front. They have been able to overcome rapid inflation, in some cases hyperinflation, and establish a reasonable degree of monetary and fiscal discipline. However, macroeconomic stability is not just about stability of prices in goods markets. Even though inflation has been brought under control, overall macroeconomic conditions, including key prices such as real wages, exchange rates, interest rates and asset prices, that exert a strong influence on resource allocation and investment decisions, have been extremely unstable in most countries in the region. This is partly due to increased payments instability associated with trade and financial shocks, and partly to a loss of macroeconomic policy autonomy resulting from rapid liberalization and close integration into the global economy. Furthermore, rather than “getting the prices right”, market forces have tended to keep interest rates and exchange rates at levels that have impeded rapid capital accumulation and technological change.

Briefly, the new policy orientation has failed to produce an appropriate macroeconomic envi-

ronment for investors and firms to encourage and support the creation and expansion of productive capacity and the improvement of productivity and international competitiveness. Neither has it been able to provide effective policy interventions at the sectoral or micro levels of the kind practised in East Asia. True, the scope for such policy interventions, through differentiated measures of support and protection, has been considerably reduced as a result of commitments to various Uruguay Round agreements such as those relating to tariffs, subsidies, trade-related aspects of intellectual property rights (TRIPs) and trade-related investment measures (TRIMs). But more importantly, the new development paradigm, the “Washington consensus”, disapproved of such selective policy interventions. Instead, it advocated that in pursuing structural policies in areas such as trade, finance, investment, technology and the public sector, most decisions on resource allocation, capital accumulation and technological progress be left to market forces.

This chapter examines the salient features of this experience in a comparative historical perspective. Section B examines briefly the evolution of economic policy in the region, which holds useful lessons for understanding current conditions. An analysis of the dilemmas generated by the new policy approach is provided in Section C with regard to macroeconomic management, and in Section D with regard to structural adjustment and development. The chapter concludes with a discussion of the options available for removing some key constraints on policy actions.

Countries in Latin America have been unable to remove structural and institutional impediments to rapid growth and structural change, despite drastic changes to their development strategy introduced in response to the debt crisis of the 1980s.

The new policy orientation has failed to produce an appropriate macroeconomic environment for investors and firms to encourage and support the creation and expansion of productive capacity and the improvement of productivity.

B. Policy cycles in Latin America: a historical perspective

The adverse impact of political instability on economic performance in Latin America is well known. Perhaps less appreciated are the sudden shifts in economic policy resulting from domestic political pressures and changing international circumstances. Indeed, the period of the 1980s and 1990s was not the first time Latin America had experimented with radical change in economic policy, nor was it the first time that it had relied on rapid and close integration into the world economy to accelerate its growth and development. Unlike the economies of developing Asia, which, despite political changes, have pursued much more stable and gradual economic policies since they achieved self-government in the second half of the 20th century, Latin American countries have experimented with a number of radically diverse development policies following their emergence from colonial rule in the first quarter of the 19th century.

During the first 100 years of its independence, Latin America sought rapid and close integration into the world economy, pursuing a policy of what is now called outward-oriented development in conditions of highly volatile capital flows and periodic financial crises (box 6.1). Despite success in expanding exports, trade was unable to act as an engine of industrialization and growth within the region because the export sector in most countries was not sufficiently large (Bulmer-Thomas, 1994).¹ Even those countries that were relatively successful in expanding the industrial sector could not translate these gains into growth of manufactured exports.

The breakdown of the global trading system and the collapse of the gold standard, followed by the outbreak of the Second World War, brought to an end this strategy of seeking outward-oriented development through close integration into the world economy. Cut off from supplies of manufactured consumption and capital goods and from financing from Europe and the United States, a new policy approach became necessary. There was little choice but to base growth and development on greater self-sufficiency, in particular with regard to financing and manufactured products, and rely on primary commodities for export earnings. Manufactured goods previously imported from Europe and the United States were to be replaced by domestic production under policies that were later termed “import substitution”, while the dependence of Europe and the United States on Latin American primary products reinforced the concentration of such products in the region’s exports. Even after the war there was little possibility of returning to the earlier policies of economic integration through trade liberalization and unhindered private financial flows, as attention was largely concentrated on European reconstruction. Moreover, the likelihood of commodity prices returning after the war to levels seen during the Great Depression and depressing export earnings and import capacity, reinforced the emphasis on “development from within”. The fact that the region experienced extremely high growth rates in the immediate post-war period increased confidence in this approach. Growth rates were similar to those experienced by the European economies undergoing reconstruction under State-directed

Box 6.1**LATIN AMERICAN “APERTURA” IN THE 19th CENTURY**

The liberation of most of Latin America from colonial rule in the early 19th century instantly opened the region to participation in the international trading and financial system dominated by Great Britain. The initial impact of this integration was conditioned by the fact that colonization had been driven by the search for precious metals. The outflow of gold and silver was accompanied by an almost total reliance on imports of European manufactures, and exports of other primary products were relatively underdeveloped. This meant that the region exhibited a structural trade deficit, with little export capacity, apart from mining, when independence produced the equivalent of a big-bang liberalization of domestic markets and deregulation of capital flows.

Between 1822 and 1825, even before formal independence had been achieved by all countries in the region, seven Latin American sovereign borrowers succeeded in selling bonds in the City of London, and numerous private companies raised capital to exploit the high returns anticipated from exploitation of the region's rich natural resources.¹ The largest borrower was what would eventually become Argentina, but sovereign debt was also sold by Brazil, Chile, Colombia, Peru and the Central American Federation. With government revenues largely composed of customs duties, and politicians loath to replace old colonial tributes with new taxes, much of the sovereign borrowing went to finance the new governments' unfunded expenses. Conditions were further complicated by the fact that non-metal exports, which had formerly circulated more or less unhindered within the empires of the colonial powers – much as in a customs union – now faced tariffs and other barriers. The resulting weak export earnings, combined with excessively high interest rates and high underwriting costs paid to London bankers,² and a growing gap between government expenditures and revenues, resulted in frequent delays in debt servicing that led to a collapse in bond prices and to an eventual default on nearly all the London bonds by the end of the decade. As a result, the region was cut off from foreign investment inflows until the middle of the century, forcing a reliance on export surpluses and internal sources of financing. This early experience thus contained many of the elements underlying some of the recent difficulties facing several countries in the region: fiscal and external imbalances financed by volatile capital flows with frequent reversals, requiring adjustment in domestic income and absorption, and producing frequent changes in economic policies.

Economic recovery started with the expansion of non-traditional agricultural exports, such as coffee, cocoa, sugar, beef and guano, under conditions of improving terms of trade, as the industrial revolution in Europe increased demand for these products. The recovery of the mining sector also helped, even though the adoption of the gold standard by the major trading countries depressed export earnings from silver. During this period there was also an increase in bilateral trade and clearing with the United States. The return of foreign investors around the middle of the century propelled technological changes in the transportation sector such as railways and steam shipping, and new techniques for refrigeration, all of which made the transoceanic shipping of agricultural products possible. By 1914, Latin America accounted for one-fifth of all overseas investment by Great Britain (with the major share going to Brazil and Argentina), over 15 per cent of investment by Germany and 10 per cent by France. As foreign investment, together with favourable commodity prices, helped raise export capacity and earnings, unlike the earlier episode of a surge in capital inflows, export earnings stayed roughly in line with the servicing requirements of external capital, and did not lead to generalized financial distress.³ However, they did serve to further increase the

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Box 6.1 (concluded)

concentration of exports of the region in primary commodities, as none of the countries managed to exploit the increased domestic industrial production capacity to expand manufactured exports.⁴ This model was thus subject to volatility in export earnings and capital flows that came to dominate the global economic landscape soon after the First World War.

¹ On sovereign bond issues, see Dawson, 1990. During the period 1822–1825, 46 joint stock companies were incorporated on the London Stock Exchange, mostly in mining. They were all insolvent by the end of the decade (Grosse, 1989: 15).

² The bonds had coupon yields of between 5 and 6 per cent and sold at discounts of up to 30 per cent. With the addition of underwriting costs, borrowers received only about 60 per cent of the face value of the loans (Dawson, 1990).

³ However, there were severe financial crises in individual countries, such as the failure of the Argentine Government to meet its interest payments on bonds issued by Barings in 1890; this resulted in a crisis that probably caused more difficulty in London than in Latin America, and required what was the first “life boat” organized by the Bank of England.

⁴ In 1913, over 90 per cent of total export earnings came from two products in three countries; over 70 per cent in ten countries (including Brazil and Chile); over 60 per cent in three countries, over 40 per cent in four countries (including Argentina and Mexico), and less than 40 per cent in one country of the region (Peru) (Bulmer-Thomas, 1994: 59, table 3.2).

recovery programmes that relied on external finance channelled through the Organisation for European Economic Co-operation.

The new strategy produced accelerated growth in the post-war period, at rates almost twice as high as had been experienced in the most favourable periods of outward-oriented expansion in the last quarter of the 19th century, and this was accompanied by stable macroeconomic conditions. As private international capital flows became increasingly important in the late 1960s, and accelerated in the mid-1970s due to recycling of the growing surpluses of the petroleum-exporting countries, strong growth in Latin America was particularly attractive to international lenders, notwithstanding the growing payments difficulties and inflationary pressures originating from the rise in petroleum prices (see chap. II). Although increased external borrowing was used to finance domestic industrialization (and, in some cases, increased military expenditures and non-productive

activities) without generating a commensurate export capacity, the growing debt-service payments did not create insurmountable difficulties as long as commodity prices were rising and real interest rates remained negative.² Indeed, the commodity boom was expected to continue, as many forecasts, such as those by the Club of Rome, predicted global shortages. However, these assumptions proved wrong as a result of the sudden shift to an anti-inflationary monetary policy in the United States at the end of the 1970s, which increased interest rates sharply. Commodity prices collapsed in the ensuing global recession, plunging the region into a debt crisis.

A development strategy based on import-substituting industrialization, that had evolved in conditions of limited trade and financial flows, proved ill-suited to the new global trading and financial environment. The search for policies conducive to more stable economic conditions, faster growth and increased debt-servicing capacity led to the

reintroduction of an outward-oriented development strategy, driven by rapid liberalization of goods markets and deregulation of international capital inflows. In most countries, although there were already pressures from domestic groups in the 1970s to return to a more liberal approach to trade and finance, with this pressure intensifying immediately after the debt crisis, the shift in policy was only fully implemented from 1989 in the wake of the Brady Plan.

Any change engenders substantial adjustment costs. However, after several years of stabilization and adjustment policies, the region is still unable to combine price stability with sufficiently rapid and stable growth and viable payment positions. Unlike some East Asian economies that have also

relied on raw materials and primary commodities in their outward-oriented development strategies, Latin America has generally been unable to translate export earnings into increased investment in order to reduce its dependence on commodity exports and improve its manufacturing capacity, productivity and competitiveness. At the same time, trade liberalization in the region has resulted in a sharp increase in the import content of domestic economic activity. Therefore, there has been a growing dependence on external capital, which has led to increasing debt-service obligations without a commensurate increase in the capacity to meet them – an outcome that bears an uncanny resemblance to the development experience that followed independence in the 1820s.

C. Policy reforms and dilemmas

1. *Price stability and macroeconomic fundamentals*

Initially, the policies introduced in the major Latin American economies to enable them to resume servicing their external debt were based on creating sufficient foreign exchange through trade surpluses, generally achieved by a sharp reduction in demand and slower growth accompanied by high inflation. This period was characterized by negative net resource flows from the region.³ Several stabilization plans and a succession of exotically named currencies, such as the Cruzado and the Austral, failed to halt inflation in these economies.⁴ An important shift occurred when the Brady Plan changed the focus for the resolution of the debt problem, from policies designed to create large trade surpluses to those that

would reduce the debt burden and improve access of the debtor countries to the international capital markets in order to refinance their debts to banks. Latin American countries were thus encouraged to introduce changes in their domestic policies and institutions to make them more attractive to international portfolio and direct investment flows. The intention was to achieve closer integration into the international trading and financial systems through a rapid, and often unilateral, opening up of domestic markets, to make trade and foreign direct investment (FDI) the engines of growth.

Domestic price stabilization was also found to be necessary for the creation of conditions that would allow the countries to return to international capital markets. The general approach was to combine exchange rate stabilization with convertibility of currencies at a predetermined nominal ex-

change rate (Argentina) or within an adjustable fluctuation band around a central rate (Mexico and Brazil). Exchange rate regimes were supported by cuts in government spending and the creation of primary budget surpluses, along with tight controls over money supply growth. The opening up of domestic markets to foreign competition was also expected to discipline domestic producers and reinforce the price stabilization policy. Public assets were privatized, often through sales to foreign investors, in order to generate financial resources for the budget as well as foreign exchange.

Although most countries that introduced exchange-rate-based stabilization policies succeeded in fighting inflation, and were praised for their macroeconomic discipline, they were not able to harness trade and FDI for rapid and stable growth in per capita incomes based on increased capital accumulation and technical progress. The basic difference from the many previously failed stabilization attempts, and the reason for their success in bringing inflation under control so rapidly, was that the rise in incomes and the decline in competitiveness caused by the use of an exchange rate anchor did not generate a balance-of-payments crisis during the disinflation process. This was because of their success in attracting capital inflows. In addition to the increase in real purchasing power due to falling inflation, capital inflows raised the prices of domestic financial assets, and hence domestic wealth; this provided an additional boost to demand and growth. However, this positive growth performance only set the stage for a return to the difficulties caused by large external debt stocks in the previous decade. Indeed, most countries have seen earlier income gains reversed by a series of recurrent financial crises. In other words, the seeds of the “lost half decade” noted earlier were sown by policies introduced in the first half of the 1990s.

The fiscal and monetary policies adopted for macroeconomic stability initially seemed to have been highly successful in Latin America. However, by overlooking the more traditional macro-

economic fundamentals, such as aggregate demand, real interest rates and real exchange rates, they created an overall macroeconomic environment that impeded achievement of the structural changes needed at the micro level, which in turn caused imbalances at the macro level to persist. Furthermore, structural changes at the macro level made these economies less responsive to traditional stabilization policies, and thus tended to generate dilemmas in responding to crises when they occurred.

Most countries that introduced exchange-rate-based stabilization policies succeeded in fighting inflation, but they were not able to harness trade and FDI for rapid and stable growth.

The policies pursued to eliminate inflation served to undermine macroeconomic fundamentals and adjustment of the productive structure due to the evolution of the exchange rate, real interest rates, and both fiscal and external accounts.

(a) *Exchange rates*

Success in fighting inflation on the basis of a stable, nominal exchange rate anchor produces an appreciation of the real exchange rate. As noted in chapter V this was generally the case in Latin America throughout the 1990s. Although use of an exchange rate anchor may be necessary in the initial stages of a price stabilization policy, it may eventually undermine the restructuring of the productive sector if real appreciation is allowed to persist. While an overvaluation of the exchange rate is beneficial in reducing the price level of imported goods, it also reduces the incentive to sell goods abroad, and enables foreigners to gain competitive advantage relative to domestic producers if the latter cannot adjust local cost and production structures rapidly. In Latin American countries, however, real-exchange-rate appreciations resulted not only from stickiness in wages and the prices of non-traded goods, but also from nominal appreciations (e.g. in Mexico and Brazil). Combined with the opening up of the domestic markets to foreign trade, this made it more difficult for domestic industry to respond to the new price and productivity structure imposed by international markets.

As in most other emerging markets that have used exchange-rate-based stabilization programmes, currency appreciations in Latin America have eventually been corrected through a reversal of capital flows. Often, there has been an overshooting of the currency in the opposite direction. While this has restored the competitiveness of domestic industry, it has also been associated with a disruption of economic activity, particularly of the import and credit systems, thereby delaying the export response to currency changes. More importantly, such gyrations in the real exchange rate have restricted the ability of industry to take a long-term view and impaired the investment in machinery and equipment needed for restructuring industry and improving productivity and competitiveness (fig. 5.3, chap. V). Indeed, a significant feature of the East Asian NIEs during their rapid pace of industrialization was their relatively stable real exchange rates until the mid-1990s. After that, they were destabilized by unsustainable capital flows, resulting in a deep financial and economic crisis.

(b) *Interest rates*

Tight monetary policies are considered an integral part of the macroeconomic discipline necessary to bring inflation under control. They generally produce high nominal interest rates that, in conditions of rapidly falling inflation rates, translate into high real interest rates. High nominal and real rates are also used as a means of attracting the foreign capital necessary to refinance outstanding debt. As a consequence, however, domestic industry encounters serious difficulties in financing restructuring; banks find it more attractive to increase holdings of high-yielding government securities – often financed by borrowing externally at lower interest rates – and they offer credit to consumers, who take advantage of domestic financial liberalization and deregulation. Business firms, facing a lack of domestic credit and extremely high domestic interest rates, also prefer to borrow abroad at much lower rates. They thus take on increased foreign-exchange exposure

that is usually not hedged because of the confidence in exchange rate stability created by the sharp reduction in inflation and the large foreign capital inflows. As a result, domestic banks concentrate on financing government deficits and provide virtually no lending to private businesses. The latter therefore have to finance production and investment either from their own funds or by borrowing abroad, with consequent increases in financial fragility.

The use of an exchange rate anchor may be necessary in the initial stages of a price stabilization policy, but it may eventually undermine the restructuring of the productive sector.

One of the basic reasons for implementing anti-inflation policies linked to exchange rate stability is the belief that these policies will bring about a decline in interest rates and financing costs, thus providing support for investment. This is because high interest rates are

believed to be caused by a large inflation premium and the high risks of currency depreciation. According to this view, a policy of lower inflation and greater exchange rate stability should bring about a reduction in nominal interest rates and boost domestic investment, without any negative impact on external capital inflows. Indeed, in Argentina, as a result of the elimination of inflation by pegging the peso to the dollar under the Convertibility Law, it was expected that domestic interest rates would converge towards those prevailing in the United States. However, tight monetary policy designed to attract international capital and induce residents to maintain local currency deposits, as well as the relatively high credit risks of Latin American financial institutions, offset much of the benefits of lower inflation and exchange rate stability. Further, the deregulation of financial markets caused a disproportionate increase in the cost of financial transactions in domestic credit markets for small and intermediate businesses. Thus they did not benefit from the preferential access accorded to large businesses in international capital markets. Disparities in access to credit and in its terms and conditions contributed to the concentration of economic power in the hands of a few economic groups in many countries in the region.

High interest rates, together with currency appreciations and gyrations, meant that monetary

conditions in Latin America in the 1990s were too stringent and unstable to provide a sound basis for macroeconomic and financial stability and encourage growth based on capital accumulation. This is shown by the movements of a monetary conditions index developed by the UNCTAD secretariat, combining the real exchange rate and the real policy interest rate and comparing Latin America with East Asia (fig. 6.1). On average, the value of the index was much higher in Latin America than in East Asia throughout the 1990s, suggesting that monetary conditions were much less conducive to investment and growth in the former region than in the latter. It was also much less stable in Latin America. During the expansionary phase in the early 1990s, the index in Latin America was high because of both currency appreciations and high interest rates. With the Mexican crisis and the downturn in growth, the index fell sharply, due in large part to corrections in exchange rates. Its subsequent upturn was mainly due to rising interest rates, needed to attract capital, and to currency appreciations in countries such as Argentina and Brazil.

In this process, increased external indebtedness and large swings in capital flows clearly played a major role, as they also did in East Asia in the aftermath of the 1997 crisis when the index became unusually unstable. In this context, it is noteworthy that monetary conditions had evolved in a similar fashion in both regions throughout the 1960s and 1970s over the stylized cycles examined in chapter IV, box 4.1; that is, they were pro-growth and stable. In Latin America, this pattern was broken with the debt crisis in the 1980s, and tight and unstable monetary conditions persisted throughout the 1990s with the opening up of the capital-account and boom-bust cycles in private capital flows.

(c) *External accounts*

In the period immediately after the implementation of the Brady Plan, when stabilization policies were introduced, most countries had rela-

tively low external indebtedness as a result of positive commercial-account balances generated during the debt crisis, a cut-back in international bank lending and debt reduction. However, after the stabilization policies succeeded in fighting inflation, rising demand and growth caused external balances to turn negative, and debt once again started to grow, encouraged also by policies to attract capital flows.

This shift was enhanced by the fact that, with increasing global financial integration, a growing share of domestic government debt was held either directly or indirectly by non-residents. In addition, the sharp rise in FDI and portfolio equity inflows increased non-resident claims on the current account in the form of profit and dividend

remittances to foreign investors. Thus factor services became an increasingly important component of the current-account balance for countries that engaged in successful disinflation by relying on capital inflows. For instance, at the beginning of the stabilization programmes in Argentina and Brazil, the shares of interest payments plus profit remittances in total current-account outlays were around 16 per cent and 18 per cent respec-

tively; by 2001, these figures had risen to 24 per cent in Brazil and 35 per cent in Argentina. While the average share of profit remittances was around 3 and 1 per cent, respectively, of total current-account outlays in the 1980s, these figures rose sharply in the 1990s due to increased FDI inflows associated with privatization, reaching 5.5 per cent in Brazil and 6 per cent in Argentina in 2001.

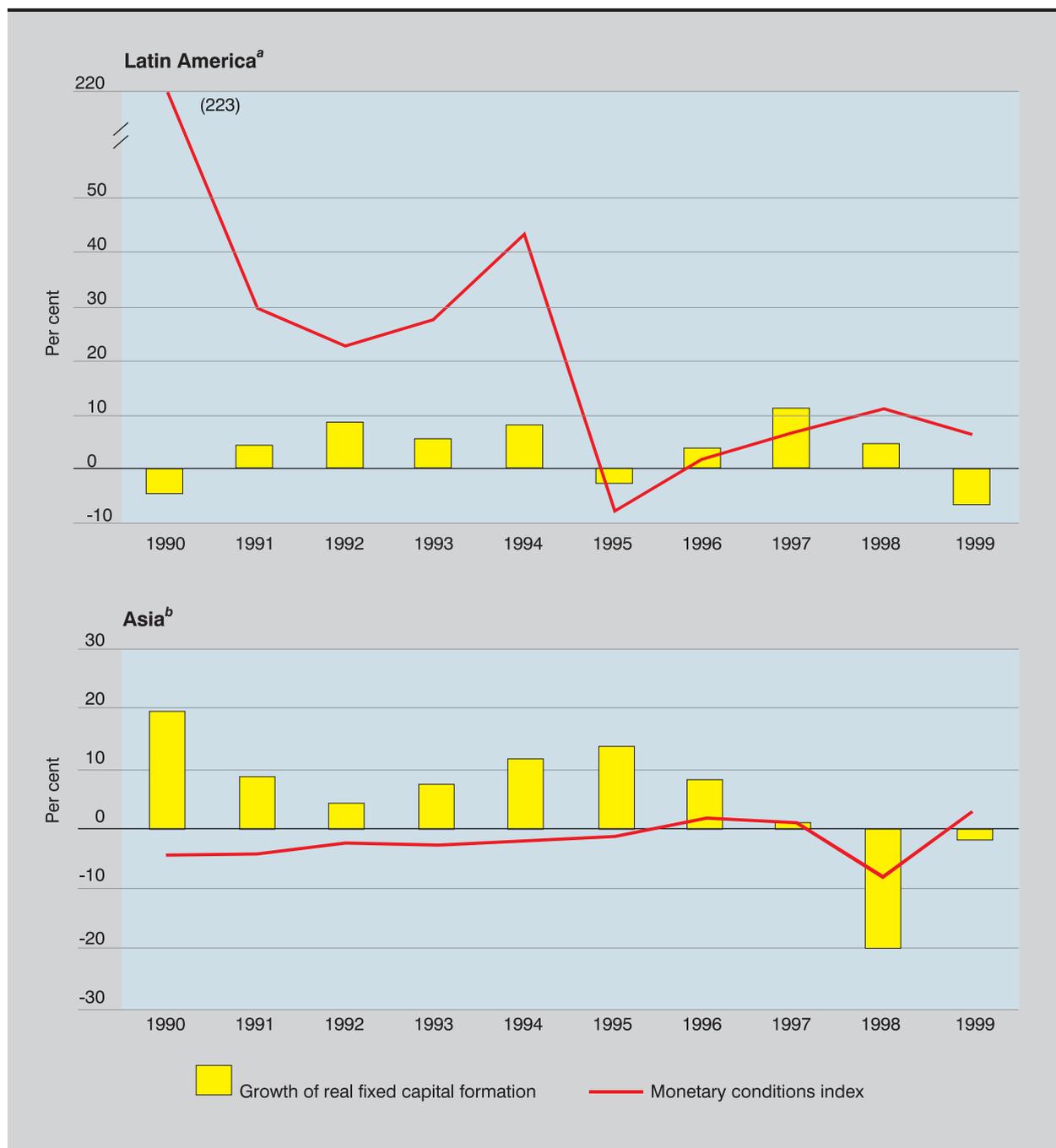
(d) *Fiscal accounts*

Similarly, the resumption of external debt accumulation in the 1990s that was inherent in the success of the Brady Plan and the stabilization programmes, and the failure of interest rates to fall, increased the interest component of current government expenditures, as governments had to refinance and issue new debt at higher interest rates. For instance in Argentina, the share of in-

Monetary conditions in Latin America in the 1990s were too stringent and unstable to provide a sound basis for macroeconomic and financial stability and encourage growth based on capital accumulation.

Figure 6.1

**GROWTH OF GROSS FIXED CAPITAL FORMATION AND MONETARY CONDITIONS
IN LATIN AMERICA AND ASIA IN THE 1990s**



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2002*; IMF, *International Financial Statistics* database; and Thomson Financial Datastream.

Note: The monetary conditions index is a weighted average of the annual change in the real effective exchange rate and the ratio of the real short-term interest rate to the trend growth rate. An index number of zero indicates neutrality of monetary conditions, a positive index number indicates restrictive monetary conditions. Weights for both components of the index have been determined by average trade shares of the countries concerned.

a Latin America includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Mexico, Uruguay and Venezuela.

b Asia includes Hong Kong (China), India, Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore and Thailand.

terest payments in total government spending rose from around 8 per cent in the late 1980s and early 1990s to over 22 per cent in 2001. In Brazil, on the eve of the launching of the stabilization programme in 1994, the share of interest payments in total government spending (after allowing for its inflation component) was around 10 per cent; this figure exceeded 30 per cent at the end of the decade.

The restrictive fiscal policy adopted in response to rising debt servicing often served to depress domestic activity and tax yields, thus increasing the size of the deficits to be financed. And it did little to reduce government borrowing costs that were set by international financial markets and by sovereign risk premiums. This adverse impact on government finances was reinforced by the negative carry on the increased foreign-exchange reserves due to the difference between the domestic interest rate paid on the bonds issued to sterilize the capital inflows and the short-term interest rates earned on the reserves (*TDR 1999*: 124). Further, the fact that real interest rates remained high, while domestic growth rates, after initially increasing, eventually stagnated, made it difficult, if not impossible, to reduce the debt burden, irrespective of the restrictiveness of government financial policies, and despite large primary budget surpluses.

Factor services became an increasingly important component of the current-account balance for countries that engaged in successful disinflation by relying on capital inflows.

2. Policy autonomy and effectiveness

The new policy orientation, particularly in countries applying exchange-rate-based stabilization programmes under free capital mobility, resulted in fundamental changes in the way the economies responded to payments or fiscal imbalances, as well as in the scope and effect of macroeconomic policies. However, the expectation that the new policy regime would provide almost automatic adjustment to payments or fiscal imbalances without too great a sacrifice in terms of growth proved to be unfounded.

For example, in Argentina, policy makers ignored the rapid increase in the external deficit in the course of stabilization on the grounds that owing to the Convertibility Law, which made it impossible for the central bank to exercise policy autonomy, an autonomous adjustment mechanism would operate similar to that presumed to have existed under the gold standard. It was believed that an external deficit would result in the erosion of foreign-exchange reserves, and thus lead to a decline in the domestic money supply. This, in turn, would cause domestic wages and prices to fall, thereby restoring external competitiveness, despite the fixed nominal exchange rate. Exports would consequently increase and imports decrease until external balance was achieved. However, this automatic adjustment process can severely affect output and employment if wages and the prices of non-tradeables are sticky downwards. Considerable deflation is then needed to achieve an adjustment in the

real exchange rate and external balance. This was the case in Argentina in the aftermath of the Mexican crisis of 1994–1995, when the external balance could not be restored despite unemployment rates exceeding 15 per cent.

Furthermore, such a process of adjustment can be disrupted by excessive capital flows. When private capital inflows exceed the level needed to finance the current-account deficit, as was initially the case in most countries in the region that used exchange-rate-based stabilization programmes, external deficits fail to curb the growth of money supply and bring about an orderly adjustment in the real exchange rate, even when wages are fully flexible. Conversely, when mounting deficits eventually result in a sharp reversal of private capital flows, reserves will decline much further than the amount of the current-account deficit, leading to a deflationary overkill. In other words, while a currency-board regime “ties the hands” of central bankers by removing their control over money creation, and thus the risk of political influence in favour of inflation, with open capital markets it simply places monetary policy in the hands of international investors, whose only ob-

jective is to maximize the return on their international investments.

There is an equivalent argument for automatic adjustment of the fiscal balance, since the central bank cannot monetize government debt unless it also acquires foreign exchange. Thus, when tax receipts fail to cover public expenditures, the government must either increase taxation, reduce spending, or raise borrowing from the private sector. On this view, any of these responses should have the same general effect of curbing domestic demand and creating downward pressure on wages and prices, causing imports to fall, and external demand to expand sufficiently to offset the fall in internal demand. However, this adjustment mechanism can also be rendered inoperative because of capital inflows. This was the case in Argentina during the first half of the decade, when revenues from the sale of State-owned property allowed the Government to continue to run deficits, thus delaying adjustment.

This means that financial markets cannot be relied upon to bring about orderly adjustment in fiscal and current-account imbalances. As long as private lenders are willing to finance deficits, the automatic adjustment mechanisms may not function as expected. Private capital flows tend to offset and postpone market-based adjustment to external and internal imbalances. When such flows are suddenly reversed as a result of mounting deficits, adjustment occurs in the form of a deep and costly financial crisis.

Changes in the composition of the budget and external accounts, resulting from a build-up of

external and internal debt, also affect the way economies respond to traditional macroeconomic policy measures for payments adjustment. By cutting government expenditures, Keynesian policies aim to create a fiscal surplus that is reflected in an improvement in the balance of payments, as declining domestic demand reduces imports and the resulting excess productive capacity is directed to exports. But when fiscal expenditures are increasingly dominated by interest payments on outstanding debt, and current payments abroad have an increasing factor services component in the form of interest payments, dividends and profit remittances, the impact of fiscal retrenchment on budget and current-account balances is greatly reduced. In other words, the amount of deflation needed to attain any given improvement in the budget and external accounts will be higher, the greater the share of factor service payments in the budget and the external account.

The basic difficulty is that, while policy on government spending may influence imports and exports of goods and services, the debt-service component of fiscal expenditures and the factor-service component of external expenditures are determined by other factors such as international interest rates, the maturity structure of the debt, and repatriation patterns, over which governments have little direct control. For instance, if restrictive demand policies raise the international risk premiums, because investors view declining growth as increasing the likelihood of an exchange-rate adjustment or the reversal of a stabilization policy, the resulting increase in interest costs may more than offset the impact of any improvement in domestic absorption on the current account.

A currency-board regime “ties the hands” of central bankers by removing their control over money creation, and places monetary policy in the hands of international investors.

When fiscal expenditures and current payments are increasingly dominated by interest payments, the impact of fiscal retrenchment on budget and current-account balances is greatly reduced.

D. Structural adjustment and imbalances

The new policy orientation in Latin America proved effective in fighting inflation by relying on capital inflows and stable exchange rates, but it also resulted in a rapid accumulation of external obligations and eroded international competitiveness. Indeed, debt burdens similar to those of the earlier crisis returned, although the type of debt changed from syndicated bank loans to bond issues, while current accounts continued to deteriorate and constrained growth. Furthermore, the rapid accumulation of domestic assets in the hands of foreigners was not associated either with the faster capital formation or increased export potential needed to generate foreign exchange to service foreign obligations. Overall, the Latin American experience does not support the underlying logic of the new policy approach, that an import-substitution growth strategy could effectively be replaced by an outward-oriented strategy simply by eliminating inflation and opening up markets to foreign trade and investment flows so as to raise efficiency and accelerate growth through rapid capital accumulation, structural change and productivity growth.

1. Transformation of the production structure

As seen in chapter V, the new policy regime proved to be no better at providing support for transformation of the domestic production structure than the previous policies of import substitution. One of the greatest difficulties faced by inward-looking development had been the failure to boost productivity sufficiently to allow real

wages to increase without damaging competitiveness and the external balance. As inflation and the external balance were directly linked, problems arose when nominal wages increased more rapidly than productivity. In many cases, this imbalance led to rising domestic prices, an appreciation of the real exchange rate and a loss of foreign reserves, necessitating restrictions on imports. Devaluation of the currency to restore competitiveness only fed domestic inflation by increasing the prices of imported goods; when nominal wages adjusted in response, an inflationary spiral was the result. The increase in real wages in excess of productivity growth thus had a counterpart in rising price levels and a growing external deficit, which could not be financed through capital inflows. This was further aggravated by declining terms of trade. The resulting payments crises were usually resolved, with IMF support, by introducing austerity measures (cuts in public spending, higher taxes and restrictions on domestic credit expansion) to lower demand until growth was reduced to the point where imports had fallen sufficiently to restore the external balance. In other words, the burden of adjustment to deal with the gap between real wages and productivity growth on the one hand, and overvalued exchange rates on the other, fell on income.

The new policy approach thus sought an alternative solution through trade liberalization. It was designed not only to open up to competition from foreign producers to dampen domestic prices, but also, most importantly, to expand export earnings through increased productivity and the introduction of new processes and products aimed at improving the competitiveness of domestic pro-

ducers. It was expected that higher productivity would allow wages to rise without creating inflationary spirals and balance-of-payments problems. The adjustment process was thus crucially dependent on accelerating productivity growth and increasing export potential through technical progress. However, the economic policies designed to fight inflation have failed to address other important prices, such as interest rates and exchange rates, that have an important impact on capital accumulation and technological progress.

As already noted, the market response to the changing relative prices brought about by liberalization in most countries was an increase in exports of resource-based products, which did not need much support or protection in view of the comparative advantage of the countries in these sectors. Machinery and equipment industries on the other hand, that had benefited from extensive protection, operated with higher import content, and supplied domestic markets, found it much more difficult to expand exports, as their competitiveness was eroded by the elimination of tariffs and an appreciation of the real exchange rate. Similarly, capital was substituted for labour, as the cost of imported capital goods fell relative to domestic labour costs, thus raising capital intensity.

The decline in the domestic machinery and equipment industries meant a reduction in domestic research and development (R&D). This problem was aggravated by the privatization of State-owned enterprises, often leading to a dismantling of their technology and engineering departments. Under import-substitution policies, these enterprises, along with public institutions and universities, had accounted for about 80 per cent of total R&D expenditures. In countries such as Argentina and Brazil, in the short space of 20 years after the Second World War, a vast technological infrastructure had been created within the public sector, financed by the State-owned development banks. Many public enterprises in

sectors such as telecommunications, energy and transportation had established their own technical laboratories that played an active role in training and human capital formation. With the opening up of the economy to trade and the privatization of public enterprises, these institutions ceased to play a key role, and these functions were frequently wound up as part of measures to improve short-term profitability. When firms were privatized through sales to foreigners, responsibility for technical research and engineering design was usually transferred to the home office of the acquiring foreign companies.⁵

Thus, in addition to the problems of incompatibility of macroeconomic, trade and financial policies, designed to achieve greater stability and efficiency along with rapid capital accumulation and growth, the shift to the new policy regime resulted in a serious setback to the development and introduction of new technology. Consequently, as seen in the previous chapter, the response to the new, more open competitive conditions was to shift the composition of output and exports away from those sectors that had the greatest potential for productivity growth as well as to reduce demand for labour.

Clearly, the origin of any improvement in the performance of an overall economy is to be found in the decisions of individual firms and entrepreneurs. Any process of overall restructuring to increase productivity should involve what Schumpeter termed "creative destruction". New, more innovative, productive and efficient firms enter the market to drive existing producers out of it. The strength of the overall investment regime had a strong bearing on the pace and direction of this process, as shown in chapters IV and V. The nationality of firms also matters. In the case of international investment or trade, there is a possibility of "destruction" occurring in the host or importing country with "creation" following in the exporting or home country of the TNCs. It has been reported, for instance, that some 7,000 Chil-

The Latin American experience does not support the underlying logic of the new policy approach, that an import-substitution growth strategy could effectively be replaced by an outward-oriented strategy simply by eliminating inflation and opening up markets.

ean firms closed down between the mid-1970s and early 1980s, most of them medium-sized, when the Chilean economy opened up rapidly to foreign competition (Mizala, 1992). Similarly, in Argentina some 15,000 firms were driven out of the market during the trade liberalization process initiated in the late 1970s. Most of these small and medium-sized firms were in labour-intensive sectors, which explains the sharp fall in the share of those sectors in total output. These firms were replaced by larger, mainly foreign-owned firms, or joint ventures with foreign firms, whose R&D and engineering capabilities were located in their country of origin. The result has been a reduction in domestic technological capability as well as an increased dependence on foreign R&D and on technology embodied in imported capital goods.

Thus it has been noted that in Latin America “the activities that have managed to ‘forge ahead’ during the last two decades are: (a) non-tradeable sectors producing services, such as telecommunications, energy or banking; (b) natural-resource-processing industries producing industrial commodities (such as pulp and paper, iron and steel and vegetable oil); (c) ‘in-bond’ assembly industries producing electronic equipment, TV and video sets and garments; and finally (d) the vehicle industry, which received special policy treatment during the course of the trade liberalisation episode.” (Cimoli and Katz, 2003: 12) Clearly, these are not the kinds of sectors that play a major role in increasing international competitiveness through R&D and technical progress.⁶

Rapid liberalization in Latin America has produced two specific but contrasting patterns in industrial specialization. Those countries most closely linked to the United States market, either through geographical proximity or formal trade agreements, such as Mexico and the smaller Central American countries, have expanded *maquiladora*-type specialized assembly industries that produce almost exclusively for the United States market or for re-export to third countries from the United States, and create jobs for

low-wage, unskilled labour. On the other hand, as noted in the previous chapter (see table 5.5), the major economies of continental South America, such as Argentina, Brazil and Chile, have expanded their resource-based industries and increased the capital-intensity of such activities, employing little labour. Both types of activity have relatively low domestic-value-added content, and neither provides the kind of transformation of the domestic production and export pattern that would allow trade to become an engine of growth.

Thus, it should not come as a surprise that export performance has also been disappointing in the first decade of the new policies compared with East Asia. Although the purchasing power of Latin American exports improved in the 1990s, more than doubling for some countries such as Argentina, Chile, Colombia, Mexico and Uruguay between 1990 and 2000, the increase was far lower than in countries such as India and China that adopted a more gradual approach to integration into the global economy (table 6.1). Moreover, import elasticities deteriorated for the three largest Latin American economies between the 1970s and 1990s. Although Brazil and Mexico succeeded in reducing their trade deficit as a percentage of GDP, this was accompanied by a significant drop in GDP growth. In Argentina, on the other hand, the increase in the growth rate was associated with a move from a trade surplus to a trade deficit.

Consequently, as demonstrated in *TDR 1999*, in order to achieve any given growth rate, Latin American countries have become more dependent on external capital flows than they were before market-oriented reforms.

This has made it more difficult for them to finance the import of capital goods and equipment required to sustain industrialization. By contrast, the relatively low import elasticity of demand observed during industrial development in the Republic of Korea and Taiwan Province of China suggests that they were able to draw on their domestic manufacturing to a much greater extent than were the Latin American countries, both dur-

The response to the new, more competitive conditions was to shift the composition of output and exports away from those sectors that had the greatest potential for productivity growth, and to reduce demand for labour.

Table 6.1

**PURCHASING POWER OF EXPORTS, GDP GROWTH, IMPORT ELASTICITIES AND THE TRADE BALANCE
IN 26 SELECTED DEVELOPING COUNTRIES, 1970-2000**

	Purchasing power of exports (1979-1981 = 100)			Average annual real GDP growth ^a (Per cent)			Import elasticity ^b			Trade balance (Per cent of GDP)		
	1970- 1979	1980- 1989	1990- 2000	1970- 1979	1980- 1990	1991- 2000	1970- 1979	1980- 1990	1991- 2000	1970- 1979	1980- 1990	1991- 2000
Argentina	66.4	99.7	198.7	2.3	-0.7	3.6	1.8	-1.6	2.8	0.6	1.9	-1.4
Bolivia	86.4	87.7	133.9	5.2	-0.2	4.0	2.5	0.0	1.4	-6.9	-0.6	-3.0
Brazil	78.6	136.4	201.0	8.3	2.7	3.0	1.1	-0.3	2.1	-4.2	0.5	-0.7
Chile	73.7	109.2	298.8	1.0	4.2	6.4	3.3	-14.0	1.1	-14.3	-4.3	-7.4
China	52.7	155.4	465.7	4.8	10.1	10.1	3.3	2.1	0.8	..	-1.3	2.4
Colombia	76.8	116.9	230.3	5.4	3.6	2.8	1.0	0.0	1.0	-0.5	0.0	-2.0
Côte d'Ivoire	84.8	108.9	117.3	7.5	0.7	3.8	1.1	-0.6	2.0	-2.3	11.9	18.4
Ecuador	62.4	90.2	113.7	9.6	2.0	1.5	1.0	0.4	1.6	-5.3	-0.1	12.3
Egypt	60.7	88.7	110.5	6.7	5.4	4.8	2.9	1.9	0.7	-37.0	-25.4	-4.8
Ghana	127.8	65.4	108.8	-0.2	3.0	4.2	2.0	-0.1	22.4	1.9	0.2	1.5
India	81.8	136.6	315.5	3.4	5.8	6.3	1.9	0.7	1.6	-1.2	-3.5	-0.9
Indonesia	43.6	95.1	176.9	7.8	6.1	3.5	1.1	1.5	-9.9	20.9	-0.1	0.8
Kenya	117.7	92.6	181.9	6.8	4.2	2.2	1.0	0.6	1.2	-22.8	-4.7	-10.7
Malaysia	59.2	140.0	520.3	7.8	5.3	6.6	1.1	1.6	1.5	5.5	0.6	0.3
Mexico	56.8	115.7	260.4	6.2	1.1	3.1	1.2	9.1	2.9	-6.1	0.6	-1.2
Morocco	84.8	131.9	283.0	5.7	4.2	2.4	1.4	0.8	1.9	-7.7	-6.0	-6.9
Nigeria	44.1	56.5	43.3	4.3	1.6	2.3	1.8	1.6	0.3	-6.1	-19.9	6.1
Pakistan	88.0	110.6	199.1	4.4	6.3	3.5	2.6	0.6	0.7	-18.1	-8.3	-0.8
Peru	68.2	81.1	106.9	3.7	-0.1	4.8	1.5	-1.1	1.2	-3.9	-1.3	-3.3
Philippines	66.0	116.6	251.8	6.1	1.0	3.6	1.2	1.4	2.1	-4.4	-1.7	-9.1
Republic of Korea	54.1	188.2	622.8	8.7	8.9	5.5	1.2	0.8	1.8	-1.6	2.2	3.9
Taiwan Province of China	80.8	189.4	478.8	9.5	8.5	6.2	1.4	1.1	1.0	0.8	8.5	2.4
Thailand	71.1	151.8	557.4	7.3	7.6	3.5	1.3	1.4	2.7	-9.3	-2.8	2.6
Turkey	..	..	..	5.4	5.3	3.8	1.1	1.3	3.4	..	..	-4.4
Uruguay	80.6	116.3	241.1	2.8	0.5	3.2	1.9	1.5	1.2	-7.4	-0.3	-8.6
Venezuela	86.3	96.4	141.7	4.0	1.1	1.1	1.4	0.6	0.4	..	11.4	18.2

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2002*; and Thomson Financial Datastream.

^a Calculated from constant national currency units.

^b Ratio between average growth in merchandise imports (in current dollars) and average growth in GDP (in current dollars).

ing the earlier period when the latter were pursuing import-substituting industrialization and during the more recent period of outward-oriented growth.

2. *Foreign direct investment, international trade and payments*

While the region as a whole has increasingly relied on TNCs for technological change and upgrading of exports, in general FDI has not been in sectors and technologies that are capable of generating sizeable growth in productivity and value added. Indeed, much of the FDI has been in the services sector, which has little impact on the value-added content of exports. Moreover, since TNCs operating in tradeable sectors use a high proportion of imported inputs, FDI generally has had a negative impact on the current-account balance, adding to external indebtedness. In Brazil, for instance, an examination of a sample of large foreign companies has shown that between 1989 and 1997 there was a marked shift away from net exports of high-tech goods (IEDI, 2002: 12).⁷ This was accompanied by a sharp increase in high-tech imports not linked to exports. Taken together, the 85 foreign companies included in the sample moved from an overall export surplus in 1989 to an overall deficit in 1997, increasing their imports at more than double the rate of growth of their exports. Furthermore, national and foreign-owned firms reacted differently to the exchange rate adjustment that occurred in 1999. National firms considerably increased their share of exports in total sales – from 12 per cent to 20 per cent – as well as the share of high-tech goods in their exports.

By contrast, foreign firms' exports fell, mainly because these went to regional markets where demand was in sharp decline, and although there was an improvement in their net balance, this was due to an even sharper decline in their imports. Despite the rise in high-tech exports of national firms, the net surplus on trade in primary

commodities is still twice that in technology goods. Similar results have been reported for Argentina. An analysis of the external accounts of the 1,000 largest firms in 1997, when its economy was still experiencing high growth, shows that these firms ran large deficits on their external trade in high-tech goods, and this was the main reason why the trade deficit in Argentina doubled that year.⁸ It has also been observed that foreign firms have an import coefficient roughly twice that of domestic firms while their export coefficients are broadly the same (Chudnovsky and López, 2002: 161). They have thus had a negative impact on external deficits and debt.

Moreover, their financial policies have also added to external indebtedness because they have financed a large proportion of their investment with loans, including from their parent companies. For example, foreign firms operating in Brazil have financed their expansion predominantly by means of increased indebtedness rather than increased equity; in 2000, for every dollar of equity, firms with foreign participation held almost two dollars of debt, of which 40 per cent was external and 60 per cent internal. Again, for each dollar of FDI, such firms held 2.5 dollars of debt, of which about one dollar was external and 1.5 dollars was internal (IEDI, 2003: 22). A similar pattern is discernible in Argentina, where a significant proportion of investment by foreign interests was financed by borrowing abroad, basically through the sale of negotiable paper and other financial instruments in international capital markets. Between 1992 and 1998, the non-financial private sector borrowed more than \$35 billion, corresponding to nearly three quarters of the borrowing by

foreign investors (Kulfas, Porta and Ramos, 2002: 19). These are all consistent with the trend observed as early as the 1970s in a study by the United States Tariff Commission covering 70 per cent of United States investments abroad in manufacturing, that multinational corporations, "in dealings with their parent company, exert a large and growing negative or adverse influence on host country balance of payments" (cited in Lissakers, 1991: 58).

FDI has not been in sectors and technologies that are capable of generating sizeable growth in productivity and value added.

Briefly, the new policies and increased FDI inflows have failed to boost domestic capital formation as the basis for transforming the composition of output towards high-value-added tradeable goods and improving export potential. The increased capital inflows needed to close the trade gap have in turn added to the external deficit, not only through increased debt servicing but

also through the adverse impact of the operations of foreign-owned corporations on the current account. The result is that economic policy has had to be constantly directed towards ensuring sufficient flows of external funds, rather than encouraging domestic capital formation and productivity growth for improving the productive base and increasing international competitiveness.

E. Policy challenges

1. *What went wrong?*

The policy reforms that were introduced in Latin America at the end of the 1980s had two main objectives: (i) to remove distortions caused by government intervention and enhance the role of markets in economic activity; and (ii) to regain access to international capital markets in order to refinance outstanding debt and provide additional resources to finance growth. These required policy reforms designed to secure monetary and fiscal discipline, eliminate inflation, liberalize markets, remove industrial subsidies and barriers to international trade and capital flows, privatize State enterprises, and create and support financial markets. Such reforms were expected to overcome the main impediments to rapid accumulation and growth, particularly balance-of-payments and savings constraints.

Although the region has succeeded in reducing inflation and regaining rapid access to international capital markets, it is generally agreed that the results “have been disappointing ... particularly in terms of growth, employment and poverty reduction...”,⁹ in exactly the same areas in which import-substitution policies had failed. However, there is little agreement on why the results have been so disappointing. According to one

view, the failure was due not so much to adherence to the “Washington consensus” as to deviations from it, including the premature opening of the capital account and the use of the exchange rate as a nominal anchor (i.e. policies which had not been included in the “Washington consensus”, at least in its original form). Furthermore, according to this view, there were important policy slippages: some of the “first generation” reforms were neglected (e.g. reform of the labour market) and there was a failure to introduce “second generation” reforms to strengthen institutions (Williamson, 2003). In short, the governments were at fault for not applying appropriately the policies prescribed by the “Washington consensus”.

This explanation of the poor policy performance leaves open the question as to whether it would have been possible, without opening the capital account, to: (i) attract the private capital needed to refinance debt and close the external deficits that had risen sharply as a result of rapid trade liberalization; or (ii) eliminate hyperinflation without using the exchange rate as a stable anchor in countries such as Argentina and Brazil that have long histories of failed stabilization plans. Clearly, policies prescribed by the “Washington consensus” encouraged the liberalization of direct investment inflows, which now consti-

tute nearly all of the capital inflows for some Latin American countries such as Brazil and Mexico, and which provided much of Argentina's external financing needs in the period 1992–2000 (see chap. II). As already pointed out, such flows have increased, rather than reduced, the external fragility of most of the recipient countries in the region.

On the other hand, while the original “Washington consensus” proposals advocated competitive exchange rates, particularly in the face of rapid trade liberalization (*TDR 1999*: 128–131), the subsequent debate has been centred on the so-called “two-corner” solution to the question of the appropriate exchange rate regime – fixed or floating. Official opinion gradually shifted in favour of the latter after the breakdown of most fixed regimes. However, as subsequent experiences in Brazil, Mexico and Turkey have shown, floating under open capital-account regimes also caused sustained nominal appreciations in exchange rates that were not corrected in an orderly way by market forces. In this respect, perhaps one of the principal failings of the “Washington consensus” was its inability to anticipate the extent of market failures in the sphere of finance – that is, the failure of international capital flows to sustain exchange rates at levels consistent with underlying economic fundamentals.

In Latin America the public appears to make a clear link between currency depreciation and inflation. Thus, whatever the particular exchange rate arrangement adopted in support of a price stabilization policy – currency board, fluctuation band or crawling peg – it had to start out with some fixed and known nominal value that was expected to be maintained for some period of time if economic agents were to use it with confidence as a reference for expectations concerning the future path of prices. Further, if capital inflows are to be encouraged, foreign investors must be

One of the principal failings of the “Washington consensus” was its inability to anticipate the extent of market failures in the sphere of finance.

The rapid lowering of inflation resulted in an increase in incomes and wealth first, before productive capacity was expanded and rationalized.

assured of some degree of commitment to maintaining the initial nominal rate. On the other hand, experience shows that once success in maintaining the nominal exchange rate has become embedded in market expectations, it becomes very difficult to engineer an orderly adjustment to regain competitiveness (*TDR 2001*, chap. V). For

instance in Argentina, there was no domestic support to adjust the currency board; in Brazil in the period before the 1998 election, it was clear that any hint of depreciation would rekindle middle-class fears of inflation, with political consequences; and in Mexico, the announcement by the new Government in 1994, that what was already an adjustable scheme

was to become slightly more flexible, was enough to trigger a wholesale collapse of the foreign-exchange market.

The overvaluation of exchange rates was clearly the result of strong capital inflows encouraged by the success of the Brady process – reinforced by the announcement of “Washington-consensus” style reforms – and, most importantly, by the extremely rapid and visible success in halting hyperinflation. As noted above, what was required for transforming the microeconomic incentives and production structure after the decision to discard import substitution was a process of Schumpeterian “creative destruction”. But the stabilization plans seem to have reversed

this process. The rapid lowering of inflation resulted in an increase in incomes and wealth first, before productive capacity was expanded and rationalized. In the presence of a more open trade regime this led to increased imports and a growing current-account deficit, which was financed by foreign investors who were attracted by the promise of higher returns. However, the

creative process of technological progress and restructuring remained to be carried out, and the macroeconomic environment of high interest rates, strong exchange rates and volatile capital flows

did little to support the new investment required for such a transformation. Thus policy reforms were unsuccessful because the “creative” element in the “destruction” process failed to bring about real transformation of the productive structure through higher investment and technological change.

2. What is to be done?

The disappointing performance delivered by the policies applied in Latin America in the 1990s has left the region with clear and binding constraints on future policy actions. The most important of these is the level of outstanding domestic and external debt, which in most countries is too high to allow rapid and steady growth. In other words, policies introduced in response to the debt crisis have left many countries in the region in conditions as fragile as those prevailing in the 1980s.

The ever-present possibility that the debt might not be serviced is the single most important reason for the excessively high international risk premiums charged on most sovereign borrowing in the region. But this only serves to increase the cost of the debt, and hence the possibility of non-payment. The belief that high domestic interest rates are required to attract the capital inflows necessary to meet the debt service keeps domestic monetary policy excessively tight. The combination of high international spreads and high nominal exchange rates leads to real interest rates that are much higher than the expected profitability of private productive assets and considerably higher than even potential growth rates, let alone the actual rates, which have been disappointing.

These policies, designed to ensure that debt servicing is met by continued capital inflows, are pursued because of the fear that any reversal of flows would have a substantial negative impact on the exchange rate and rekindle inflation. It is

believed that this would more than offset any benefits that may result from increased competitiveness and exports. Hence, the only policy tool that remains to offset the increasing debt-service burden and avoid an unsustainable rise in the ratio of government debt to income is the generation of higher primary surpluses through expenditure cuts and tax increases.¹⁰ However, any increase in the primary surplus, to accommodate the higher cost of debt servicing, can also make it more difficult to sustain public debt by depressing economic growth. Indeed, such a response to increases in interest rates can lead to an unstable process, and eventually to default.¹¹ In this process, at some point the ratio of sovereign debt to national income may also reach a level at which foreign investors lose confidence and reduce their lending or even repatriate their funds; that is, the government would be unable to borrow even at very high interest rates. At this point net exports would be forced to cover not only the interest costs but also the capital outflow. This would entail a reduction in growth and employment, and would eventually lead to a financial crisis.

A viable exit from this vicious circle of low investment and growth, high interest rates, and rising indebtedness may call for direct action to reduce the burden of debt service. This was eventually tried in Argentina, but the approach came too late, was too haphazard and lacked credibility because it was repeated at excessively short intervals. Under the Brady Plan, interest rates were cut as the probability of repayment increased following the restructuring. Similarly, in the current situation, for any restructuring to be credible it must include a renegotiation of interest rates to levels closer to the real returns that can be earned from investment. This must also be accompanied by a reduction of domestic policy rates. In the last analysis, the capacity to repay debt depends on the health of the economy as a whole; debt service can be met only if countries come close to reaching their potential growth rates. Current policies to maintain debt service prevent this from occurring, and are thus unsatisfactory for both creditors and debtors alike.

Policies introduced in response to the debt crisis have left many countries in the region in conditions as fragile as those prevailing in the 1980s.

A second area where a fundamental change of policy may be needed is FDI. As noted above, in Latin America, as opposed to East Asia, FDI inflows tend to contribute to financial instability because they cause a deterioration in the external accounts and an increase in the level of external obligations without generating the potential to service them. If trade is to be an engine for growth of national income and for growth of profits of TNCs, FDI must serve to improve domestic technology, increase productivity and provide for a competitive export sector in high-value-added manufactures, thereby improving the stability of the external accounts and reducing reliance on external borrowing. This may require the use of performance criteria for FDI of the kind once applied in Asia. The Mexican example shows there is no guarantee that increasing the share of TNCs' manufactured exports will generate similar increases in national income. Unless a strong export base also makes a strong contribution to domestic value added, it will not support trade as an engine of growth.

A full range of policies of the kind pursued in the more successful East Asian economies will need to be reconsidered.

While essential, a new policy approach to external debt and capital flows will not be sufficient to revitalize the Latin American economies. A full range of policies of the kind pursued in the more successful East Asian economies will need to be reconsidered. This includes policies designed to reduce dependence on foreign capital (as well as to improve its use), encourage technological progress, increase the extent to which profits are reinvested, discourage luxury consumption and speculation, and improve public investment in key areas of human and physical infrastructure. It is true that the scope for such policies has been restricted by multilateral commitments undertaken in the context of WTO negotiations or regional and preferential trade and investment agreements. However, it appears that in most countries there is more policy space than is currently being used. To determine exactly what this space is and how it could best be used requires the kind of basic research on industrial and development policies that has not been particularly fashionable in the recent period of financial orthodoxy. ■

Notes

- 1 According to this author, only in Argentina and Chile was trade capable of acting as an engine of growth for the entire economy.
- 2 According to a former Brazilian central banker, “We said from the economic point of view, it is correct for Brazil to borrow rather than adjust. ... The interest rate [on foreign loans] was negative, and there was a positive real return on money here”, quoted in Lissakers (1991: 64).
- 3 This was not the first time the region had experienced this phenomenon. In a speech at the end of 1951 Brazilian President Getulio Vargas complained that Brazil had been experiencing negative net liquid financial outflows almost continuously from 1939 (see Moura, 1959: 26–27). According to ECLAC (1959: 29), Argentina had also experienced net outflows of about \$46 billion during the period 1900–1944.
- 4 For example, Brazil implemented 9 stabilization plans, 15 wage policies, 19 adjustments to the exchange rate regime and 20 fiscal adjustment programmes during the 1980s (Miranda, 1996).
- 5 Cimoli and Katz (2003: 387–411) note that the launch of the Taurus by Ford Argentina in 1974 required 300,000 hours of work by a team of 120 engineering specialists, while today Ford employs no engineers in Argentina to produce the “world car”.
- 6 For a similar conclusion, see Dijkstra, 2000.
- 7 The data represent a sample of 185 large firms, 80 with national ownership and 85 with foreign ownership, operating in Brazil from 1989 to 2000 (Instituto de Estudios para Desenvolvimento Industrial (IEDI), 2002).
- 8 Kulfas, Porta and Ramos (2002: 88) note that of the total commercial deficit of \$2.216 billion for 1997, transnational firms operating outside the natural resources and extractive sectors accumulated a deficit of nearly \$5 billion, while national firms in the same sectors registered a surplus of nearly \$1 billion (estimates from a panel study of the 1,000 largest firms). In sum, for 1997, which is representative of the expansionary phases of the economy in the 1990s, the operations of foreign firms caused the total commercial deficit of the country as a whole to double.
- 9 This is the opinion of Williamson (2003: 2), who coined the term “Washington consensus”.
- 10 When the sum of the real rate of growth of the economy plus the primary surplus as a per cent of GDP is less than the interest payments as a percentage of GDP, the debt/GDP ratio will grow indefinitely. On unsustainable debt burdens, see Krueger (2002).
- 11 If the debt/GDP ratio were 80 per cent, the interest rate 10 per cent, and the growth rate 5 per cent, a primary surplus of at least 3 per cent of GDP would be needed to stabilize the debt ratio. If the interest rate were to rise to 12 per cent, the primary surplus needed would have to rise to 4.6 per cent. If, as a consequence, the growth rate were to fall, the primary surplus would need to be raised even further. The decline in growth would reduce tax revenues, making it more difficult to generate primary surpluses. Moreover, it could lead to an increase in the risk premium, thereby pushing up the interest rate further.

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