

The Macroeconomic Environment for Competitiveness in Latin America¹

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1. Introduction

Looking back at the economic history of Latin America in the last quarter century, it is possible to identify a number of troublesome features: low average economic growth; high inflation relative to other parts of the world; high volatility regarding terms of trade, capital flows and economic performance; fluctuating exchange rates; balance of payments crises; high unemployment; and widespread poverty and income inequality. If this is all that characterized the performance of the region, there would be little hope for it. But the picture is different as the interested observer looks at more recent years and more detailed numbers. Inflation has been declining; exchange rates in real terms have stabilized; macroeconomic indicators have improved with regard to the fiscal accounts, and monetary policy; international trade has boomed; poverty has been in the decline; and the external accounts are much stronger than they have been in many years. Is this attributable to good luck, favorable world conditions, or hard work? The answer, typically, is a combination of the three. And to avoid simplistic generalizations, not all countries have done equally well, or have acted in a similarly prudent fashion. This chapter seeks to attain a complex task. Under the basic premise that macroeconomic stability is a pre-condition for competitiveness, it will review some of the key principles that determine the basis for good macroeconomic performance, the recent experience of the region in this regard, and some lessons for the future.

2. Macroeconomic management and the impact on competitiveness

In most debates, competitiveness is associated with the real exchange rate, namely the movement in the exchange rate between a country and its trading partners, in comparison with the relative price developments. The Real Effective Exchange Rate (REER) is defined in simple terms as:

$$REER = \sum (ER_i * (P_A / P_i) * \alpha_i)$$

Where ER_i represents the bilateral exchange rate between a specific country or region A and a trading partner i , P_i is the price index (consumer, producer or equivalent in country i and P_A is the price index in the home country or region, and α_i ² is the weight given to the particular country i in the index. Unless otherwise indicated, throughout this chapter an increase in this index measures an appreciation of the currency and a decline, depreciation.³

¹ This chapter was written, during Mr. Loser's tenure as President of Centennial Group- Latin America, Senior Fellow at the Inter-American Dialogue, and Adjunct Professor of Economics at George Washington University. This chapter has benefited enormously from the author's association with the three institutions, particularly the Inter-American Dialogue, and his President Peter Hakim, as well as his previous thirty year association with the International Monetary Fund. Extremely useful comments were provided by different colleagues, and particularly P. R. Narvekar and Graciana del Castillo, colleagues at the Centennial Group.

² The weight α_i can represent either the weight of trade with the specific country, or the participation of country i in total trade for a specific market or commodity when it incorporates export competitors.

³ The Real Effective Exchange Rate Index may be defined in terms of units of local currency per unit of foreign exchange, or conversely the cost of a unit of local currency in foreign currency. In this chapter the REER is defined in terms of the cost of a unit of local currency in foreign currency. In this definition an increase in the index constitutes an appreciation of the local currency, and a decline constitutes depreciation. This is the common

The concept that a more depreciated exchange rate enhances competitiveness is a truism—a depreciation of the currency makes exports more attractive and imports less. However, this narrow view disregards the broader aspects of competitiveness, measured in terms of increased productivity, an increasing traded-goods sector, and a stronger balance of payments. Actually, the exchange rate may be responding to external or domestic developments. When a country confronts declining demand for its products, or more specifically falling terms of trade, the exchange rate will likely depreciate. The same can be said about a domestic crisis, which can result in/ or be caused by massive capital outflows, thus resulting in adjustments to the exchange rate. Alternatively it is possible to envisage situations where the exchange rate may appreciate, on account of favorable external or domestic conditions, sometimes even resulting in an “overshooting” of the currency.⁴

An equally important aspect that is frequently overlooked in discussions about the exchange rate is that, for a given set of technologies, and capital investment, the real exchange rate is the counterpart of real wages in the economy. Thus, a marked depreciation of the currency is most likely accompanied by a decline in real wages, as the main mechanism to increase competition. The opposite is true regarding an appreciation of the currency, which is frequently accompanied by higher wages, even though they may not be sustainable. Thus, it is important to see that the main motors of sustained growth are developments in productivity, and in human capital embodied in the labor force, rather than by movements in the exchange rate alone. The exchange rate will provide the room for an improved competitive environment, but without new investment, broadly defined, such competitiveness will not allow for sustained growth

The experience of Latin America is full of examples of such movements, frequently associated with serious domestic and external events. The macroeconomic response to these events has been central to how the economy has reacted to these events, and how this affected the medium term prospects of the economy. Figure 1 shows the movement in the REER since 1990, and illustrates the fluctuations in this series. Figure 2 shows the high correlation between the REER and real wages. In this case the series is a weighted average for the seven largest countries in the region, which constitute some 95 percent of total GDP for the region, and excludes the Caribbean.

definition in the IMF and most international financial institutions. In Latin America the converse definition is used more often. IMF, World Economic Outlook.

⁴ The term “overshooting of a currency”, refers to a movement of the currency beyond what is predicted to be the longer term equilibrium value of the currency. This tends to occur at the outset of a currency crisis, or at times of a positive confidence shock, which may reflect a short-term over investment in the particular currency over the short run.

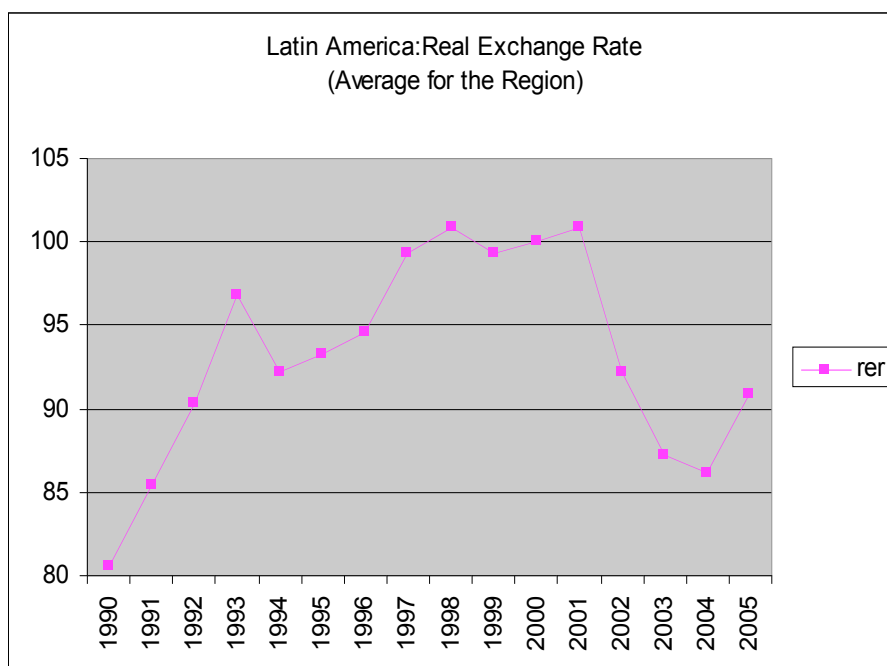


Figure 1 Source: IMF, and author's estimates

1/ An increase of the real exchange rate index indicates an appreciation

The episodes of increased competitiveness in the region have tended to be associated with declines in average wage. However, other factors may have resulted in deviations as was the case in 1994, when the Mexican peso depreciated sharply late in the year, but wage developments only reflected the shock subsequently, in 1995

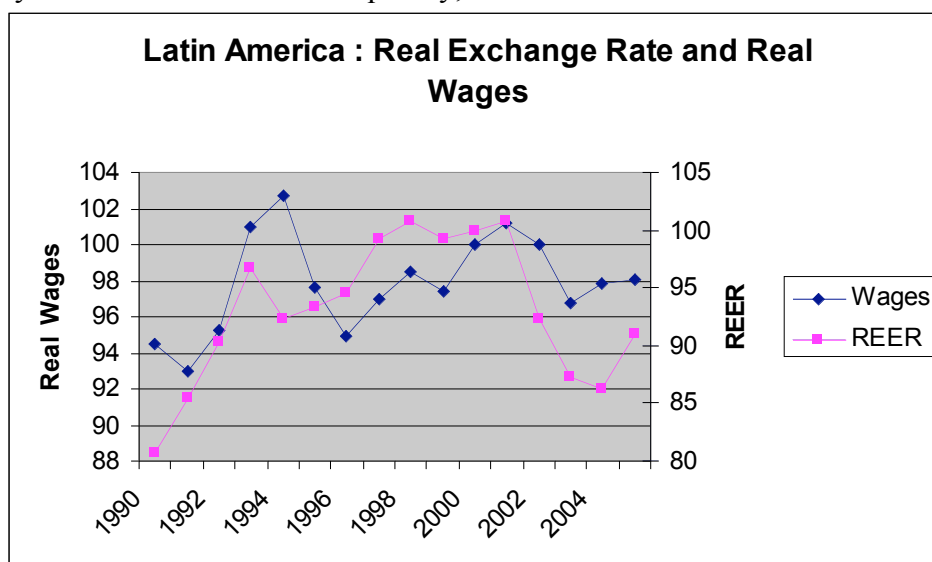


Figure2-Source: IMF, ECLAC, and author's estimates

1/ An increase of the real exchange rate index indicates an appreciation

. The “high” exchange rate/ low wage outcome cannot be considered as a sustainable solution for the countries in the region, if the main economic policy objective is to increase the well-being of the population at large. An adequate balance between these variables is a necessary

condition but by far cannot be seen as the best outcome from a welfare point of view. However, it has been a characteristic of Latin America at least for the last quarter century, as the next sections will show.

3. Economic Growth Performance in Latin America

a. Overall trends

The Latin American region has been characterized by high volatility and limited overall growth, at least since the advent of the debt crisis in the early 1980s. After a period of rapid growth based on high commodity prices (mainly for oil) and heavy borrowing, economic growth came to a halt. Commodity prices collapsed and interest rates rose, as advanced economies, particularly the US and Europe, started to correct inflationary pressures. As capital flows dried out, Latin America was confronted with the need to redress its structural imbalances. The 1980s was a period of democratic consolidation and of major reforms, but also of economic upheaval, and became commonly known as the *Decada Perdida*, or Lost Decade, at least economically. During the period after 1980, Latin America grew at a slower pace than the world at large, with the exception of the period of reform and opening that took place in the early 1990s (Figure 3). Even that most recent period was followed by several years when the region suffered a sharp decline in the rate of growth, as Brazil, Argentina and Uruguay had major problems after following the Mexican and Asian crises. Meanwhile, other regions, particularly China and other countries in Asia recovered from their own crisis. It has to be noted, however that the pace of economic growth declined world-wide, and not only in the region.



Figure 3-Source: IMF, WEO and author's estimates

A related and dramatic picture emerges when a comparison is made about the cumulative per-capita growth in Latin America and in other regions. Latin America has been characterized by

a high per capita income, among developing countries. The region had a per capita income of about US\$4500 in 2005. It is far lower than the levels of Advanced Economies, and lower than the per capita income of Eastern and Central Europe, but higher than that of other developing country regions. The rankings narrow when the data is adjusted for purchasing power, i.e. for the purchasing power capacity taking into account domestic prices, both for countries above and below Latin America, but still the region remains at the higher end of the developing countries (Figure 4). Of particular interest, the per capita income of the advanced economies is about four times that of Latin America in purchasing power terms, because of lower prices for many goods and services in the region.⁵

Figure# 4

Per Capita Income(Current US\$ and PPP-equivalent, 2005)		
Region	Current US\$	PPP 1/
Africa	992	1342
Central and Eastern Europe	6591	5850
Developing Asia	1198	2681
Middle East	3956	3588
Latin America and Caribbean	4499	4499
Advanced Economies	35350	17795
1/The estimate for purchasing power parity has been normalized on the basis of the per capita income of Latin America, for comparison purposes Source: IMF, World Economic Outlook, April 2006		

While the region remains ahead of others in per capita levels, it has fallen well behind, in terms of cumulative growth. Figure #5 presents the per-capita income for the region and others, with a common central point (1990=100). Even excluding from the base the dismal period of the 1980s, the region has stayed behind, except for a short period in the 1990s. Not only did developing Asia move much faster but the advanced economies also grew faster than Latin America. The Figure does not indicate that per capita income has fallen behind, but that from a common starting point the region has lost the advantage it may have had before. Such performance does not bode well for the establishment of an environment conducive to enhance competitiveness.

The picture presented so far is not promising, but is it an accurate assessment of the situation in the region? The answer is clearly more complex and positive. The remainder of the chapter will analyze the different aspects of macro-economic performance and policy that generally suggest a more prosperous future for the region.

⁵ When factors other than per capita income are taken into account, like longevity and levels of education, the region fares better than when looking at income alone. The Human Development Index developed by UNDP on the basis of the noted indicators shows the region a very close third after the Advanced Economies and Central and Eastern Europe.

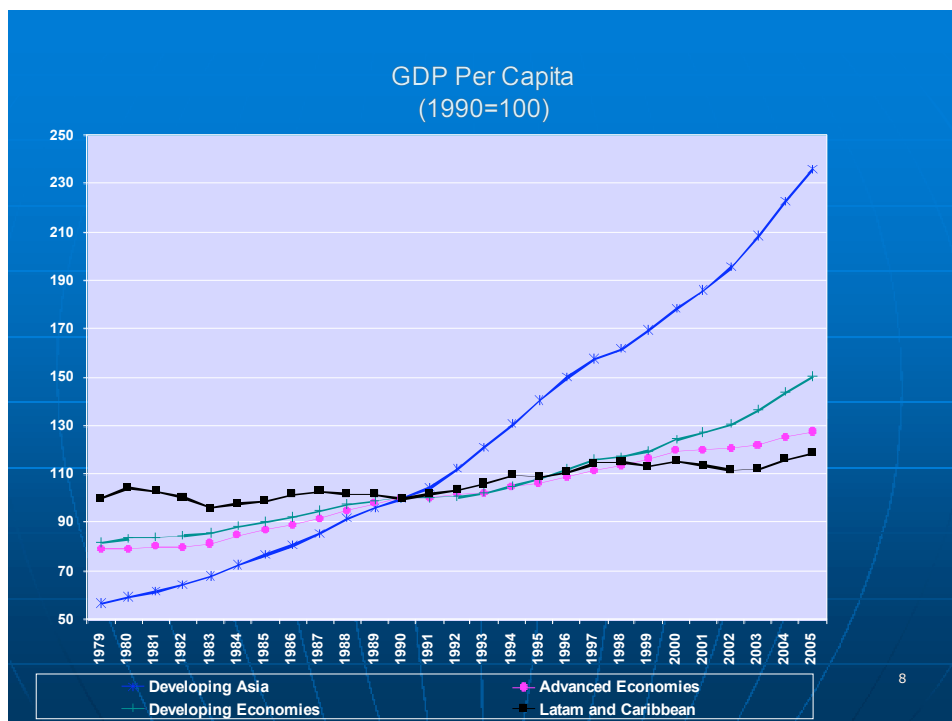


Figure 5: Source: IMF, WEO and author's estimates

b. Performance by Country

A first observation is that the region cannot be seen as a single entity. Performance among the different countries in the region has been divergent, with some countries performing very well, while others did poorly. Table # 6 provides information on the average economic growth rate, for the countries in Latin America and the Caribbean, ordered by descending order of their growth rates for the period 1990-2005. It provides some noteworthy insights. Not surprisingly, Chile the stellar performer of Latin America comes first, although not for the sub period 2001-05. Trinidad and Tobago (a major oil and gas producer) and Belize come as close seconds. They are followed by most Central American countries, the Dominican Republic (a strong contender in more recent years), Peru, Argentina and Mexico among the larger countries. However, Argentina fell below the average in the recent five years; on account of the serious crisis it suffered in 2001-02. A clear conclusion is that it is extremely difficult to come up with a general statement on economic performance in the region, except that the larger countries, except for Chile and Peru, have done relatively poorly during the period, while some of the smaller countries did well, on account of an array of serious reforms introduced during the period, as well as favorable circumstances in some cases.

Figure 6:

Latin America and the Caribbean: Average rate of Growth 1990-2005

Country	Av.1990-2005	Av. 2000-05
Chile	5.6	5.2
Trinidad and Tobago	5.3	9.2
Belize	5.3	7.7
Panama	5.2	4.6

Costa Rica	4.7	4.1
Dominican Republic	4.5	4.5
El Salvador	3.8	2.4
Bolivia	3.6	3.4
Guatemala	3.5	3.2
Peru	3.5	4.7
Argentina	3.4	2.2
Honduras	3.2	4.7
Nicaragua	3.2	3.9
Mexico	3.1	3.2
Colombia	3.1	4.0
Guyana	3.0	0.0
Ecuador	2.9	4.8
Latin America	2.9	2.3
East Caribbean Countries	2.8	2.3
Venezuela	2.7	3.5
Uruguay	2.3	0.9
Paraguay	2.1	1.9
Brazil	2.1	3.1
Suriname	2.0	5.1
Bahamas, The	1.9	2.5
Barbados	1.2	2.2
Jamaica	1.1	1.8
Haiti	0.0	-0.5

International Monetary Fund, World Economic Outlook Database, April 2006

c. Poverty and Income Distribution

Latin America is characterized not only by a wide dispersion of economic growth performance, but also serious issues regarding poverty and income distribution. While the two issues cannot be seen as being equivalent from a conceptual point of view, they are closely interrelated. Latin America does not have by any means the highest levels of poverty in the world. Moreover there has been a steady, albeit slow progress in this area in recent years, as conditions have tended to improve over time. As shown in Figure# 7, total poverty ⁶has declined by almost 16 percent in the last 15 years, and indigence or extreme poverty by 25 percent. However this decline has not been steady, mainly on account of the crisis experienced by Argentina, Uruguay and Venezuela, in 2001-02, which resulted in a sharp increase in poverty in those countries at the time, and were only reversed recently. Of equivalent importance, poverty rates are only now decline to the levels prevailing just before the oil crisis of the 1980s, when the region was expanding at a very rapid, though unsustainable rate.

Poverty has been accompanied by a highly concentrated distribution of income in many countries in the region. Indices such as the GINI coefficient, which measures inequality in income distribution within a country, show a fairly unequal distribution. On a scale from 0 to

⁶ Poverty is defined by ECLAC on the basis of a "poverty line", established on the basis of the cost in local currency of a representative basket that covers an agreed level of basic needs.

100,⁷ Latin America has a coefficient of 52, compared to a coefficient of 44 for Africa, 43 in East Asia and the Pacific, and 32 for OECD (developed) countries as well as for Eastern Europe.⁸ These indicators have to be interpreted cautiously, but nonetheless provide a good idea of the problems that the region confronts and affects competitiveness. While indicators have improved in recent years, significant portions of the population are excluded from education (about 10 percent of the population is illiterate); good health (10 percent of the population is undernourished, 11 percent have inadequate water supplies, and 25 percent have no sewage); and work opportunities (10 percent urban unemployment).⁹

Poverty Incidence in Latin America (in percent of population)

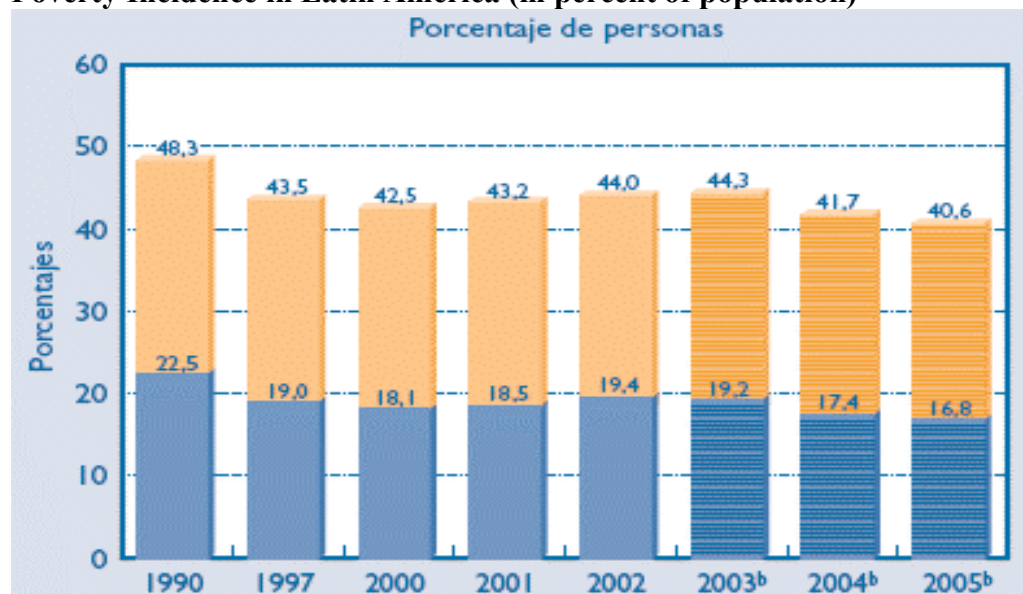


Figure 7-Source:ECLAC; (b. Estimates(should be footnote)

4. The Curse of Inflation

Before the 1990s the Latin American region had been for long the worst performer with regard to inflation. A poor appreciation of ongoing monetary developments and policies, and significant fiscal imbalances, as well as a stop and go approach to prudent macro economic policies resulted frequently in major inflation shocks. Since the end of WW II, Latin America had taken a policy approach that mixed highly protectionist industrial policies, together with a narrow interpretation of Keynesian policies, so much in vogue after the great depression. In practice governments acted on the assumption that an expansionary fiscal and monetary policy could deal with economic growth in the longer run, without any consideration for domestic and external constraints. These policies and the political incapacity to restrain wages resulted in sharp bouts of inflation and balance of payments crises, followed by major depreciations of the currency. These domestic policies, compounded by a high volatility of external conditions resulted in a sharp increases in prices, to almost 500 percent in 1990. (Figure # 8) Individual

⁷ The Gini coefficient is built so that a value of 0 reflects perfect income equality among individuals, and a value of 100, represents a totally skewed income distribution.

⁸ Human Development Report, 2005, UNDP, and World Bank Reports. The distribution among individual countries in Latin America is also significant, ranging from a low of 45 for Uruguay and highs of 57 for Chile and 59 for Brazil. By comparison the index is equivalent to 26 in Norway, 41 in the US, 44 in China, and only 32 in India.

⁹ ECLAC, Social Panorama of Latin America, 2005, provides a detailed description of current social conditions in the region.

countries had a differential performance, from very low level for fully dollarized countries like Panama, or strictly pegged ones like the English Caribbean, to a peak rate of some 25,000 annual percent rates in Bolivia in 1984.

Over time, Latin America learned to cope with inflation, although it was not able to tame it for long. Indexing schemes, freezes, predetermined exchange rate depreciation schedules, resulted in short term slow-down in inflation, but eventually most attempts failed, through the early 1990s.

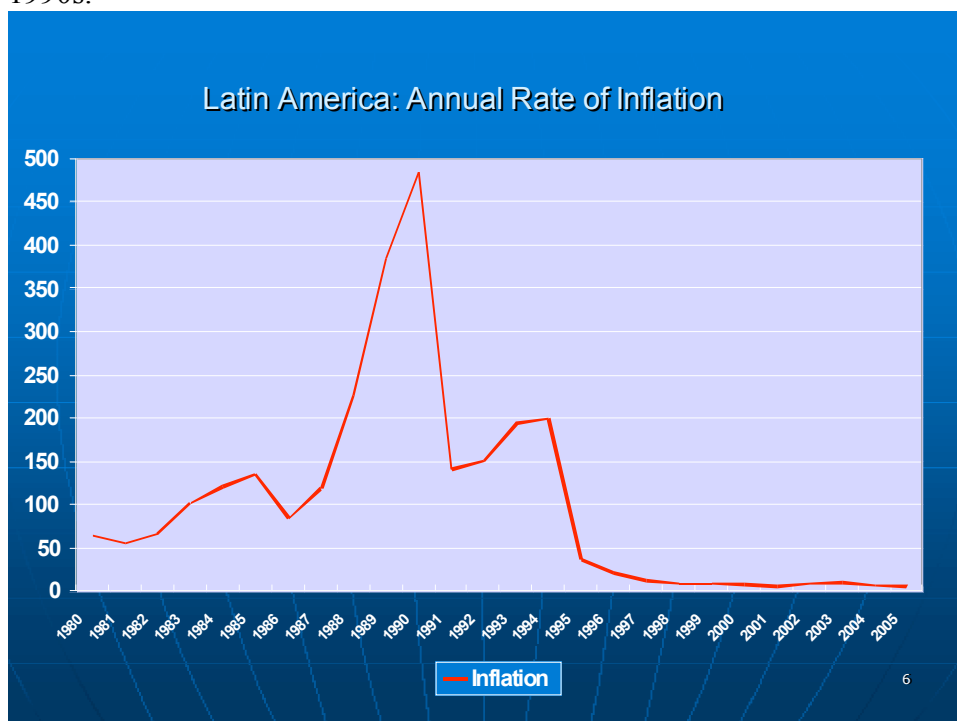


Figure # 8-Source: IMF, WEO and author's estimates

The costs of inflation ended up being very significant. Inflation, recognized as the most regressive tax as it affects the poor the most, contributed to the low growth track record of the region, until efforts started in earnest to reduce inflation. These efforts were widespread, both among larger and smaller countries.

The efforts in Brazil were arguably the most interesting as the government pursued a policy of de-indexation by the introduction in 1994 of a new currency, the real, which was intended to adjust for the previous indexation.¹⁰ The results were initially spectacular, as inflation declined sharply in the face of the de-indexation process. The country continued to grow and the exchange rate appreciated in real terms. However, in the end Brazil fell into the same trap that many countries experienced before (Argentina, Chile, and Uruguay in the 1970's) and after (Mexico, and Argentina, in the 1990's). It focused its attention on the stability of the exchange rate, without paying sufficient attention to other macroeconomic variables, like monetary and fiscal policy. Eventually, with mounting debt, increasing public sector deficits and intractable external imbalances the Brazilians had to modify their exchange rate policy, and started to adjust public finances, as described below.

¹⁰ Fernando Henrique Cardoso: *The Accidental President of Brazil*, a Memoir, Public Affairs, Washington DC 2006.

In any event, the efforts to reduce inflation succeeded in the region and inflation converged quickly, although not fully, to existing rates of inflation in the rest of the world. The decline in inflation is possibly one of the main gains observed in the region in the last decade, arguably together with the opening up to international trade. Even if the spread regarding the rate of inflation among different countries may be significant, there has been a clear tendency to lower inflation rates, as can be seen in Figure 9 below. Still, possibly reflecting the requirements of structural and social policy changes, the rate of inflation for the region remains above that of the rest of the world.

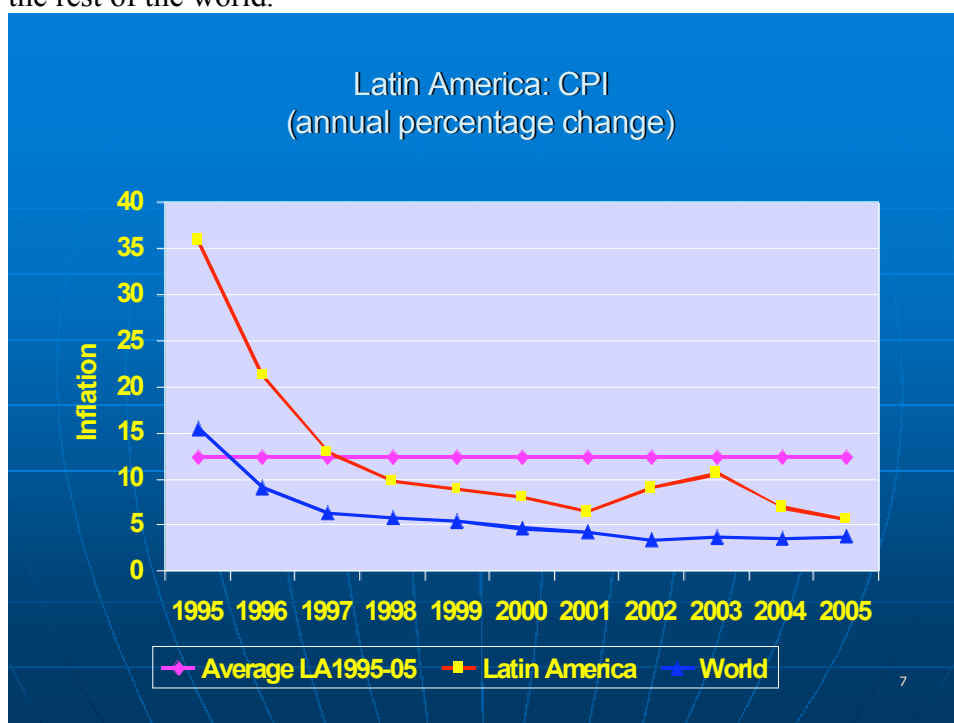


Figure #9 Source: IMF, WEO and author's estimates

Another important development is that inflation in different countries has tended to converge, as can be seen in the Figure # 10 below, for Brazil, Chile, and Mexico. While the specter of hyperinflation seems to have disappeared from the region, several countries have seen high rates of inflation, by regional standards. Venezuela has exceeded the average for the region systematically, while Argentina has seen its rate of inflation increase to the two digit range. A few other smaller countries also have been subject to these pressures, including Costa Rica, Haiti, Jamaica, Nicaragua, and Suriname, which reflect a weak implementation of monetary policy. However they represent a minority among the countries of the region, which has seen a strengthening of monetary policies over the last fifteen years or so.

Different countries have implemented inflation targeting as their main policy mechanism, most notably Chile, Colombia, Peru and Brazil. Mexico has not introduced inflation targeting as an explicit monetary policy, but in practice also follows that approach.¹¹ All these countries have

¹¹ **Inflation targeting** is the common name for a monetary policy whereby the monetary authorities define a target rate or range for domestic inflation. On the basis of the divergences between the target rates of inflation and the actual rates, the monetary authorities adjust their interest policies, to attain the targeted rate of inflation. This policy approach assumes (with considerable reason) that the relationship between monetary aggregates and inflation cannot be predicted accurately in the short run, but that inflation will react to a change in the policy stance in a

been successful in reducing inflation from the high levels observed in the 1980s and in the early 1990s.

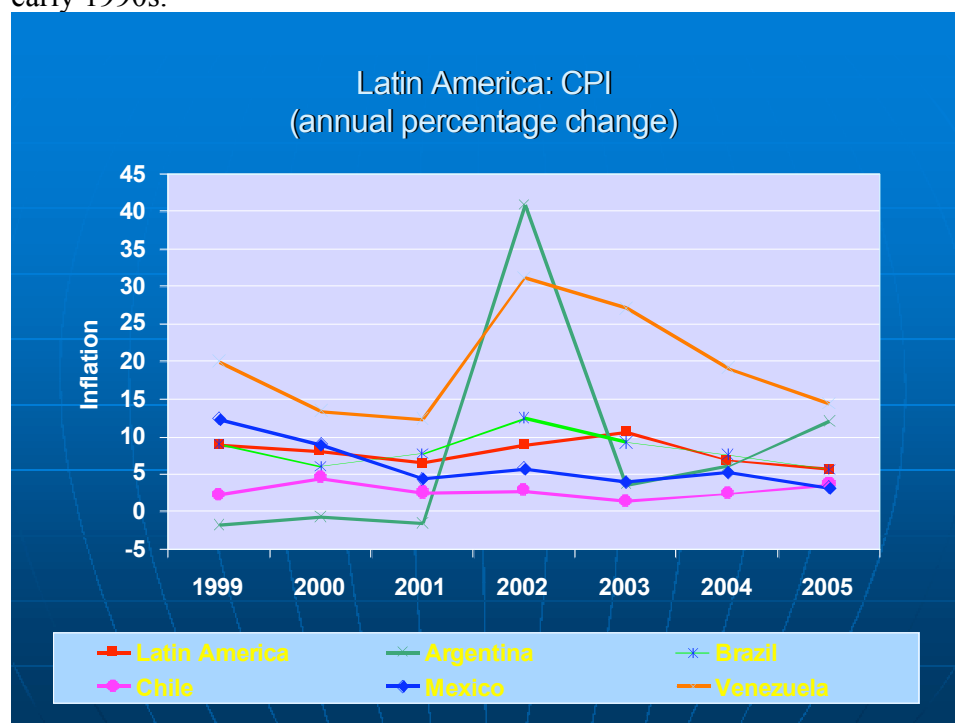


Figure # 10: Source: IMF, WEO and author's estimates

5. The links to the External Sector.

a. Trade Flows in Latin America

Latin America has witnessed a struggle almost since Independence between the wish to be autarkic and having strong links with the outside world. The autarkic forces reached their maximum importance during the Import Substitution Industrialization efforts of the post World War II Period.¹² In turn, the periods of close relationship with the external world, extended from the mid-XIX Century to the time of the Great Depression. The most recent period of Globalization that became evident in the 1990s was not unlike the previous period of British promoted free-trade.

Throughout the period of import substitution and integration, Latin America foreign trade has remained dependent of primary commodities, even as its productive base became diversified, with the possible exception of Mexico in recent years.¹³ Figure. # 11 illustrates these results, with particular emphasis on South America and Mexico. Such dependence is subject to

predictable fashion. This approach, followed by the UK, New Zealand, and countries in Latin America, was developed in response to the more traditional approach, which targets monetary aggregates on the assumption of a well known and stable relationship between these aggregates and the rate of price increase. The difference between the approaches is less significant than proponents of each approach may suggest, as they both emphasize the use of the same monetary instruments as a way to control inflation, although the money supply or credit approach emphasizes the use of an intermediate objective, domestic credit, as a means to control prices.

¹² See Bulmer Thomas(2003), and CAF (2005)

¹³ The integration of Mexico with its North American neighbors under NAFTA resulted in a sharp increase in trade between the three member countries. Mexico increased its manufacturing exports significantly, but to a large extent these exports entail a relatively low value added based on assembly activities or maquilas. Accordingly the high percentage of manufacturing exports needs to be viewed with caution.

debate¹⁴, which escapes the scope of this chapter, although there is no definitive proof that a greater weight of industrial exports increases welfare. What is clear is that the high dependence on primary commodities has resulted in major fluctuation, and generally in a secular decline in the region's terms of trade.

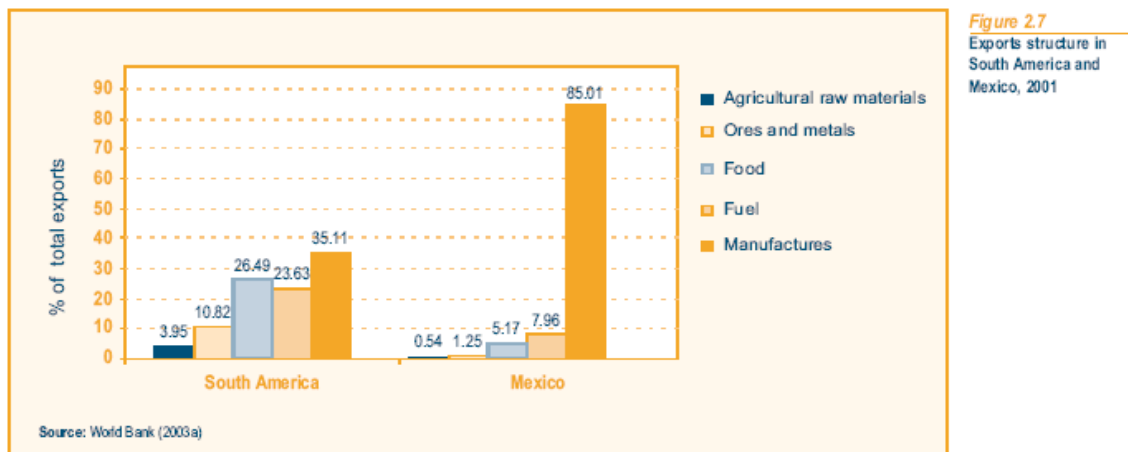


Figure # 11:Source, CAF, Recovering Growth in Latin America

The region has seen large fluctuations in its terms of trade, while at the same time it has been affected by fluctuations in demand for its industrial products. The region has had the largest variability in exports of any large developing country region, and certainly much higher than that of industrial countries.¹⁵ As a consequence, the rate of economic growth of exports for the region has been highly dependent on the behavior of the world economy, either through changes in volumes or in terms of trade, which have tended to decline as well over the medium term. (Figure # 12) In turn, this has had a significant impact on the behavior of GDP in Latin America and the Caribbean. The terms of trade variability was accompanied by a large volatility in income. In fact, the ratio of the standard deviation to the average rate of growth for the region is the highest, together with Sub-Saharan Africa, among developing countries. This situation has generated a difficult environment for policy making in the region, resulting in stop-and-go cycles that have precluded stable conditions that could help enhance competitiveness.

¹⁴ CAF, Recovering Growth in Latin America

¹⁵ The standard deviation of the annual percentage change in terms of trade for Latin America and the Caribbean was close to 4.4% compared to 1.65 for developing Asia, and 1% for the Advanced Economies.

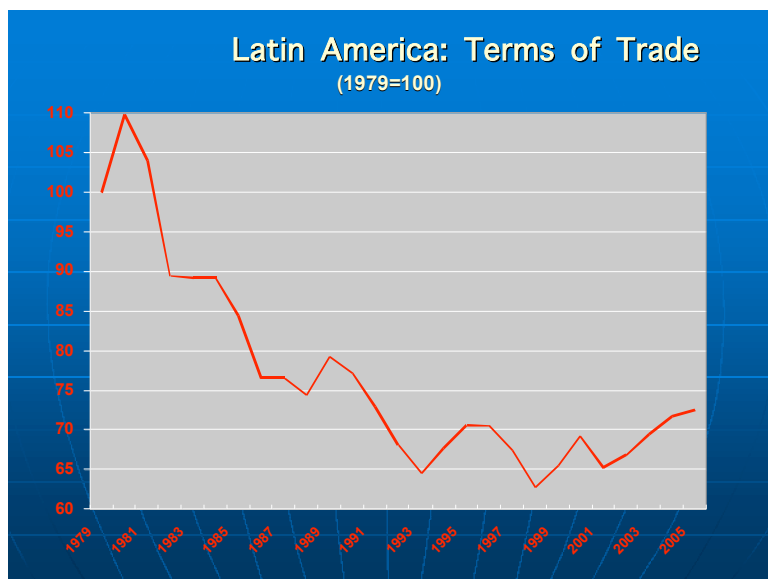


Figure # 12-Source: IMF, WEO data base

In itself, volatility in terms of trade should not be a source of lower income. Under normal conditions, countries could adjust their policies to account for the volatility of their external income, through countercyclical policies, that is policies that would help absorb resources during times of bonanza, and free them at the time when the favorable conditions reverse. However, this policy has been pursued only to a limited extent in Latin America. Expansionary policies were carried out at times of expansion, with no accumulation of reserves or reductions in debt that could have helped at the times of recession. Accordingly, the effect of external volatility could not be mitigated at times of slowdown, and often declines in terms of trade ended in serious crises. In recent years, only Chile, and to a lesser extent Venezuela, Mexico and Trinidad and Tobago followed countercyclical policies. While it would not be easy to prove, in the latter cases, the accumulation during the periods of oil-boom was more the result of a slow pace of adjustment of government expenditure to higher incomes, rather than a properly designed countercyclical policy.

An additional observation about the trade pattern of the region is that in recent years the importance of trade has increased significantly for the region. However, and after the efforts at integration resulted in an increase in intraregional trade, in recent years the share of regional trade has remained broadly unchanged.

The increase in trade has been associated with a sharp decline in the trade restrictiveness that characterized the region previously. Figure # 13 shows the changes in trade restrictiveness¹⁶, and also the ratio of exports and imports to GDP. Contrary to the fears that a decline in protection to domestic industries would result in a flood of imports and no incentives to exports, both magnitudes have increased significantly over the last 15 years. This behavior suggests strongly that the opening of trade in the region, one of the most important developments of the 1990s in many of the countries, had a major impact in increasing the integration of Latin America to the world economy, and provided an effective increase in competitiveness. The external current account in turn was dependent on other factors,

¹⁶ The index of trade restrictiveness includes information on tariff and non-tariff barriers to trade. It has been built as a simple weighted average of the index of tariffs and an index of quantitative restrictions, based on World Bank information.

including the availability of financing, the exchange rate and the macroeconomic policies that the countries in the region followed during the period.



Figure # 13: Source: World Bank, IMF WEO, ECLAC and author's estimates

While the increase in trade reflected in part the process of integration in the region, this has been only a small contributing factor. For example, trade within Latin America and the Caribbean rose from 17 percent of the total trade in 1990-91 to 19 percent in 1997-98, and was at about the same level in 2004-05. Over the same period trade with the US was the highest of any region, with 41 percent in 1990-91, 47.5 percent in 1997-98, and about the same level in 2004-05. Over the same period trade with China rose sharply, but by 2004-05 constituted only some 4 ½ percent of the total in 2004-05. In the end the reduction in restrictions has been more important than the efforts to integrate the region.

b. Capital Flows and the Balance of Payments

One of the most dramatic findings with regard to the behavior of the Latin American economy is the high dependence that the region has had on private capital flows, both in the form of foreign direct investment, and portfolio flows. Figure#14.shows the behavior of the external current account of the region, and that of private capital flows, in the period 1980-2005. The graph is striking in the high correlation between the two variables. With some lag, the current account follows closely the behavior of private flows. It suggests that Latin America has been strongly dominated by these flows, and that economic policies had to adjust to this reality, in terms of adjustments in public and private expenditure.

An initial observation about the nature of these capital inflows is that they have tended to increase in times of economic bonanza and high liquidity and were reversed subsequently as

conditions changed, at least until the early 2000s.¹⁷ This was the case in the period ahead of the debt crisis of 1982, the opening of the Latin American economies in the early 1990s, and the period through the peak of the Plan Real in Brazil, in 1998. The availability of financing and a favorable climate for investment resulted in a large expansion of the public sector expenditure, as well as private sector investment.

As conditions reversed, for example at the time of the financial tightening of 1981-82, or in the mid 1980s when oil prices plummeted, borrowing countries in the region, were seen as a high risk by foreign investors. High public sector deficits and growing debt burdens appreciated exchange rates, and at times overexposure by the private sector on account of this appreciation, resulted in a major reversal of capital flows, with the consequent need to adjust the current account. While in these circumstances, the public sources of financing, particularly the IMF and other International Financial Organizations, like the World Bank and the IDB were expected to provide countercyclical funds, their ability or their willingness to lend were far lower than the decline in private financing. Accordingly, the countries had to correct to a large extent their previous imbalances, in order to reduce their debt burden and have access to the more limited official resources.¹⁸

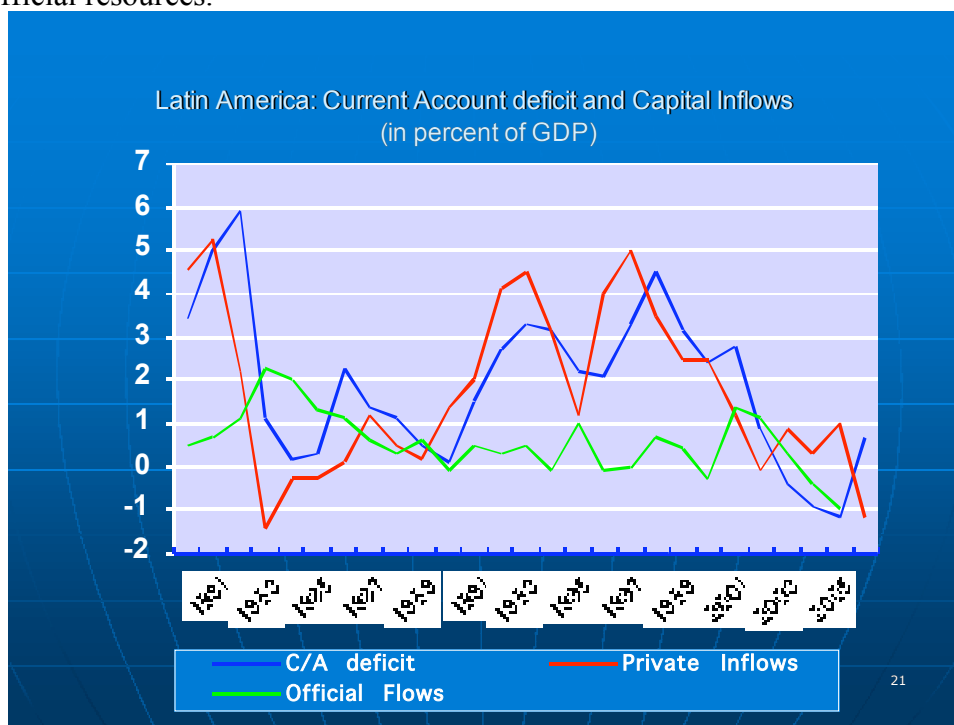


Figure # 14-Source:IMF, WEO and author's estimates

It is only in recent years, after the Brazilian (1998-99) and Argentine crises (2001-03) that a different pattern has emerged. As countries were extremely affected by earlier crises, they started

¹⁷ Capital inflows and outflows have been volatile for most countries in the region, notwithstanding the presence of direct control on inflows (Brazil, Chile and Colombia), or subject to strict prudential regulations, at least in the banking system (Argentina).

¹⁸ The International Monetary Fund was created and has operated as lender of last resort, at times of financial crisis. However, according to its Articles of Agreement and its practices, it is has not been expected to provide a full compensation for the loss of resources from the private sector. On the contrary, the principle has been to provide resources in support of policies that would make the countries less dependent on financial shocks as those observed in Latin America.

pursuing stronger macro-economic policies. The new stance, in addition to the increase in terms of trade of the recent past, allowed countries in the region to improve their external current account balance and accumulate reserves. This led to the reduced dependence on foreign financing and generated greater financial stability than in any other period in recent memory. Thus the region has been able to experience more rapid growth, and generally a lower rate of inflation, aided by the resurgence of foreign financing and the growing presence of foreign remittances by local émigrés, particularly in Mexico, Central America, Ecuador, and the Caribbean.

c. Remittances

In 2005, remittances to Latin America, from different sources (mainly, the US, Europe, and Japan) amounted to about US\$50 billion (more than 2 percent of the region's GDP), or about the same as the amount of foreign direct investment to the region, providing significant support to the economies of the receiving countries.¹⁹ While it is difficult with current information to determine the exact amount of remittances that is consumed and saved at home, it is clear that savings from remittances have acquired more importance and have replaced foreign funds in financing investment. This trend has not eliminated the typical volatility that has characterized external conditions in Latin America that was noted before, but has reduced its magnitude, thus helping attain more sustainable economic growth.

The benefits of remittances to the countries in the region are clear. However, some issues may affect competitiveness. Remittances provide a network of protection to the remitter's families, mostly among the poorer segments of the population. These resources are used for basic necessities, education and health, main contributors to human capital in the receiving countries, as well as to some other type of investment, including housing and the creation of micro-enterprises. Nonetheless, the emigrants are frequently among the most enterprising and productive members of their communities. In those circumstances, the question, which will remain largely unanswered here, is whether the loss of income at home is larger than the income generated by the emigrants abroad. The tentative answer is that the productivity will be higher abroad, in so far as there is no complementary capital in the Latin American environment that could help increase the productivity of emigrants, had they stayed at home.

A second issue is the effect of remittances on the overall stance of the economy. The presence of large flows into the economy is likely to result in a real appreciation of the currency of the receiving country, as illustrated in Figure # 15, which shows for seven receiving Latin American countries, the REER (with an appreciation as a positive change), and the per capita remittances to the receiving countries. The key issue that remains is if the appreciation will have an adverse effect on the growth prospects of the economy. In practice, the effect of remittances is the same as that of a finding of new exports (Dutch disease²⁰) or of a change in

¹⁹ Remittances have become a decisive element in the determination of the balance of payments, poverty alleviation and economic growth for the countries of origin of emigrants to the USA, the EU, Japan and other countries (including within Latin America). The significance of these flows for the Latin American economy cannot be underestimated for those countries that are major recipients of these flows, like Mexico, most Central American and Caribbean countries, as well as Bolivia, Colombia, Ecuador and Peru. The behavior of remitters has been well covered by the literature within and outside the region, with significant contributions by the Inter-American Dialogue, the IDB, and a number of other academic and international organizations. . Among the different conclusions about how individuals act regarding these remittances, one of great policy significance is that these are voluntary transfers among individuals, and thus are better left alone, without official intervention to channel these flows to alternative uses.

²⁰ The term Dutch Disease originated from the effect that gas findings in the North Sea had on the Dutch economy. It was found that the increase in the supply of exports would lead to an appreciation of the local currency, with an

terms of trade. The effect will be an appreciation of the currency but it will not be detrimental to the well being of the population at large, as income (including remittances) has increased. In the end, even if there were clear negative effects from remittances, they need to be accepted as part of the process of globalization, which will in practice entail not only movements of goods but of labor and capital. In this regard, the policy issue that confronts the national authorities, is to create the conditions for increased domestic and foreign investment that enhance the prospects for growth in the countries that now see a major emigration, like those in the Andes, Central America, the Caribbean and Mexico.

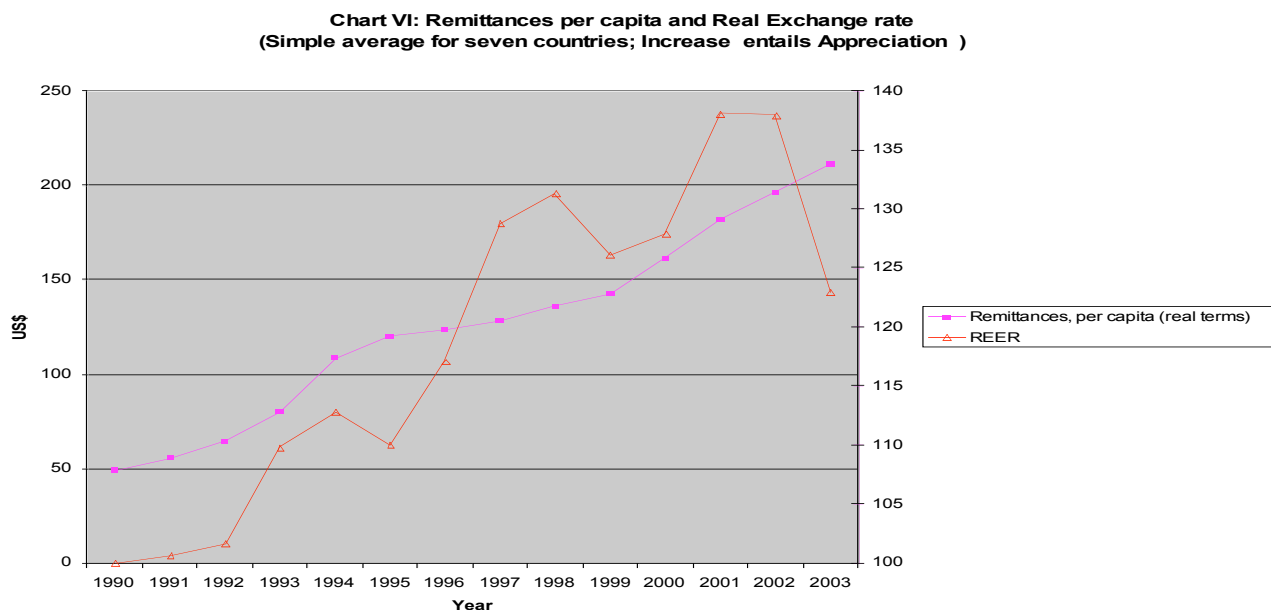


Figure # 15-Source: World Bank, WDI; IMF, and author's estimates

6. Macroeconomic Policies in Latin America

So far, the discussion in this section has been devoted to the macroeconomic environment that characterizes the countries in the region. This section aims at reviewing the macroeconomic policies that have been applied in the region.

Over the last quarter century macroeconomic policies were reactive to changes in the conditions in the world economy, and as a consequence they were eminently pro-cyclical in nature. Accordingly, at times of high capital inflows, the current account of the balance of payments deteriorated, either reflecting an appreciation of the exchange rate that accommodated these flows, or because of a fiscal expansion, financed by such capital flows, and resulting in a deterioration of the fiscal balance and thus of the external current account. Eventually, as external debt mounted and capital flows reversed, or the terms of trade deteriorated, the external current account conditions could not be sustained, and the authorities were forced to implement tighter fiscal and monetary policies, while the exchange rate adjusted to deal with the gap. This was the case in particular as international reserves were very low and the ability of the countries to borrow from the official sector (IMF, World Bank, and other multilateral and bilateral creditors) was very limited.

adverse effect on other exports or import competing items. The term is now used as a description of the same or equivalent (higher prices for commodities) effects in other economies.

Latin America: Current Account, Capital Flows and the Exchange Rate 1/

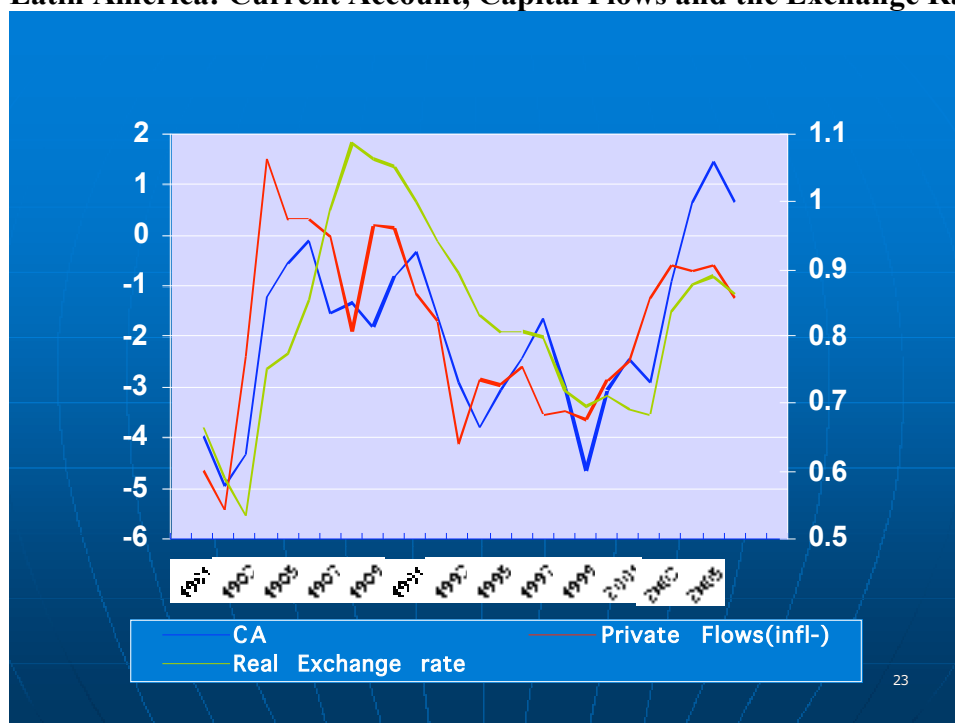


Figure #16: Source: IMF WEO, and authors estimates

1/ An increase in the exchange rate index entails a depreciation

Figure# 16, which is based on Figure 14 above, provides an illustration of the link between capital flows, the current account and the exchange rate. The volatility of capital flows and the pro- cyclical economic policies had a seriously adverse effect on investment, savings and economic growth, and eventually on the exchange rate. It is worth noting how closely associated the level of investment was on the availability of foreign financing, thus helping point out again the vulnerability of these economies to exogenous financial shocks.

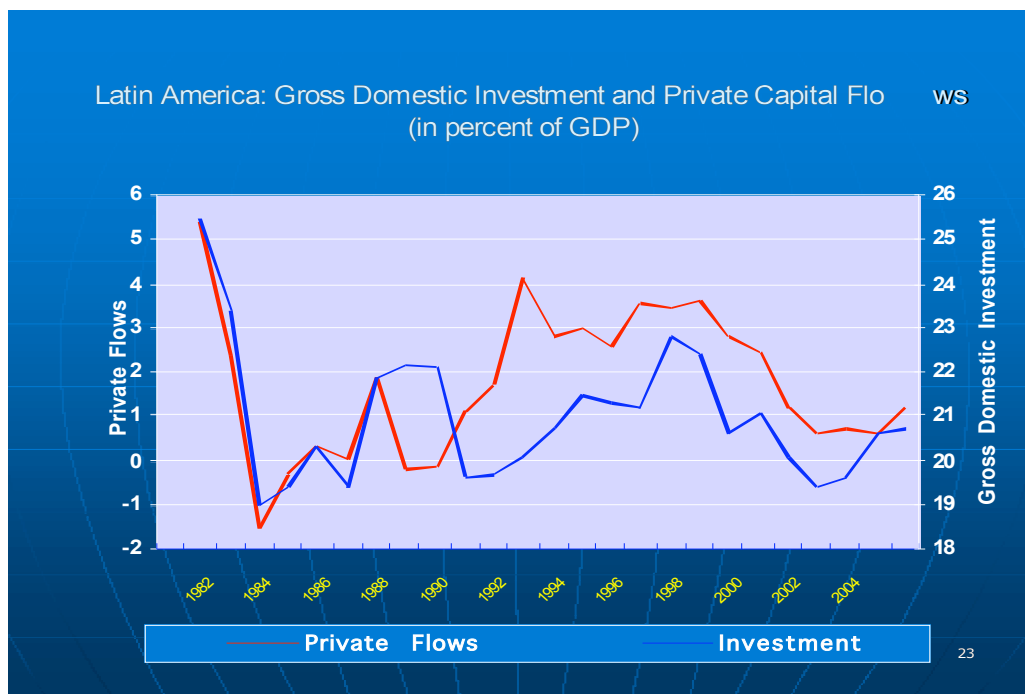


Figure # 17-Source: IMF, WEO and author's estimates

In addition to the exchange rate, fiscal policy also reacted to the external shocks. The close link can be seen in Figure # 18 that shows the current account, the fiscal balance and the exchange rate behavior in the period 1994-2005.²¹

²¹ Because of the effect of inflation on the fiscal accounts, particularly the effect of nominal interest rates, the series for the public sector deficit prior to 1994 does not provide a meaningful measure of adjustment in the fiscal accounts in real terms. However it could be approximated with concepts like the primary balance (the fiscal accounts excluding interest payments, or the operational balance, which consists of the fiscal accounts excluding the inflation component of interest payments). However, these numbers are not presented here to avoid a multiplicity of concepts that would detract from the main point of the link between fiscal adjustment and external adjustment.

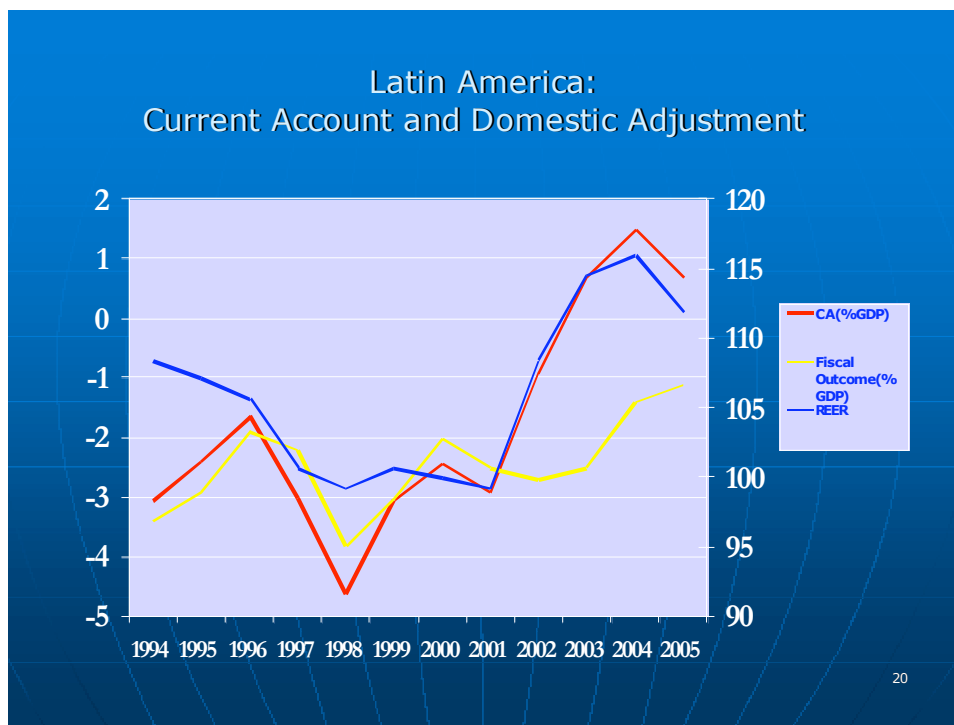


Figure # 18 Source: IMF, WEO and author's estimates

1/ An increase in the exchange rate index entails a depreciation

The stop-and-go fiscal policy process that was so typical of the region through the mid-nineties had a very adverse effect on the conditions for investment and growth. This was further compounded by an accommodating monetary policy that resulted in high and variable rates of inflation. For many decades and until several years ago, this vulnerability of the economy generated a very adverse environment for competitiveness. Clearly, the variability of the real exchange rate, wages, and real interest rates made it extremely difficult to invest in long term projects on the part of the private sector. Only very high yielding or short term maturity private projects were implemented, while creating incentives for continued capital flight. The high rate of return did not mean that only financially sound projects were incorporated. Frequently, the existence of trade or tax preferences made certain undertakings particularly appealing. However, there was a discrepancy between the private returns and the social rates of return. These projects (import substituting industries, non-traditional exports, utilities entailed high costs to the society at large. The direct participation of the public sector in certain economic activities (utilities, transport, extractive industry, etc) further complicated the profitability and competitiveness of the economy, as normally profitable activities (frequently in the export sector) were heavily taxed, or had to make use of expensive inputs. Moreover, the stop and go policies, and the corresponding changes in private flows ended up having significantly negative impact on investment, which was highly dependent on these flows.

7. Developments in Macro Policies in Recent Years

In the 1990s many Latin American countries got engaged in what later became known as the Washington Consensus, shorthand for market-friendly reforms, including on taxation, public

finances, financial sector reform, trade, privatization, and labor reform.²² The favorable impact of these policies on the region's performance was dramatic, even though certain countries went through major crises, as was the case of Argentina, Brazil, and Mexico. Most likely, the most favorable development has been that inflation has declined to levels well in line with the rest of the world, as monetary policy became more effective, the financial system was liberalized, and fiscal imbalances were reduced.

The decline in fiscal imbalances has been particularly steep in recent years as the larger countries in Latin America, Argentina, Brazil, Chile, Colombia, Mexico and Peru adjusted their finances. A marked improvement in their fiscal primary balances (the fiscal account excluding interest payments and the key indicator of fiscal policy effort) rose. The effect on the overall fiscal balance of the region has been notable, and should be seen as the main contributor to the break from the past, when the regional economies were particularly vulnerable to external shocks. These trends are presented in Figure#19.

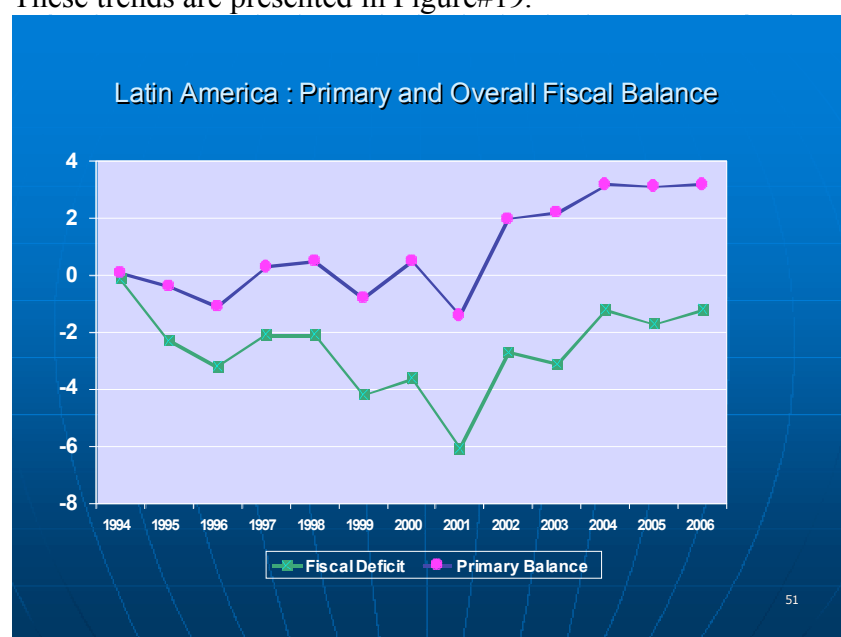


Figure # 19 Source: IMF, WEO data base, and author's estimates

Expenditures have been rationalized, without reducing significantly the resources devoted to social consolidation. Taxes have tended to be streamlined, and revenues have increased, only in part on account of higher export revenues, associated with a favorable environment. Moreover, either through an improvement in the management of public enterprises or their privatization, these enterprises have stopped being as drain on the public finances.

Public debt has declined markedly, from 32 percent of GDP in 2003, when it reached the highest point in recent years, to 22 percent in 2005, as many countries, including Brazil, Chile and Mexico

²² The Washington Consensus, a term coined by John Williamson of the IIE, was the alleged common view of the US government, the IMF, World Bank and the Inter-American Development Bank, to incorporate market reforms. Actually it was a movement which started in Chile in the 1970s and Mexico in the 1980s. Because of guilt by association with serious financial crises in the region, today the Washington Consensus has been declared a failure by many, as described in Birdsall's Washington contentious. In fact it was the lack of sufficient reform, accompanied by a limited emphasis on social policies, as well as institutional buildup that generated the problems that parts of the region is facing today..

reduced their deficits²³. These efforts have been supplemented by the noted improvement in monetary policy, and a, generally more solid financial system, and a deepening of financial intermediation. The reduction in the levels of debt and a general decline in interest rates and spreads for the region have helped improve the conditions for a more sustainable path for economic growth.²⁴

In the more recent past the performance of the economy has been also supported by a sharp improvement in terms of trade, as shown in Figure #12. In this regard Latin American governments may have become confident that the changes are of a permanent nature, and may be tempted to adjust policies accordingly. However, the turbulence that has become evident in 2006, suggests again that this is not a sustainable situation, as commodity prices are characteristically cyclical, and they may decline in the near future, with adverse effects on the public finances and the balance of payments.

8. The Bottom Line

Latin America has gone a long way in the management of its macro economic policies. The external environment has not been benign, as the economies of the region were highly dependent on the behavior of their terms of trade and the volatile availability of private financing. Over a period that extended through the 1980s, the countries in the region were not able to ameliorate the effects of these unpredictable conditions. Weak revenues and money losing public enterprises made the control of the public finances very difficult. With limited external reserves and cyclical availability of foreign financing, they made use of domestic credit financing, resulting in high and volatile rates of inflation.

This macroeconomic environment was detrimental to innovation and productive investment, and may explain the extremely poor performance of the Latin American economy during the period. Furthermore, the attempts to stabilize the economies through exchange rate anchoring plans resulted in episodes of real appreciation, supported by heavy borrowing. These episodes eventually failed, resulting in deep balance of payments crises, and sharp exchange rate adjustments. These fluctuations further affected competitiveness.

Only in the last fifteen years or so, have these conditions changed, although not in all countries and not at all times. External conditions remain volatile. However, in response to the experience of the 1980s and 1990s, countries in the region have made a determined effort to reign in their macro economic policies. Monetary policy has helped tame inflation, and fiscal policies have become much more effective in dealing with previous domestic policy shortcomings and external volatility. Exchange rate conditions, helped by flexible regimes, have provided a more stable environment, and are creating the conditions for enhanced competitiveness. It is likely that a new era has begun, where the macroeconomic conditions for trade-related growth are more predictable and stable.

All this progress does not mean that the conditions for enhanced competitiveness have been established for good, that the macro conditions will remain favorable, or that other structural policies are being pursued appropriately. Competitiveness remains fundamentally dependent on improved technologies, better education, an improved business climate, a stronger legal, regulatory, and judicial framework, a better physical and social infrastructure, and access to

²³ The Argentine case constitutes a special case. After it suffered its worst economic crisis in recent history, in 2001 the authorities announced a default on their external debt. Following several years of tough negotiations, the public debt was subject to a significant restructuring and cut in its face and net present value. As of the time of this writing this issue has not been settled fully, as a significant number of creditors did not accept the deal.

²⁴ WEO, April 2006

financing in a competitive environment. However, it means that for the first time in many years, macroeconomic policies stand on a more rational basis and bode well for a favorable future for the region.

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