

## A PRO-GROWTH AGENDA FOR LATIN AMERICA

R. Glenn Hubbard

Chairman, Council of Economic Advisers

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The countries of Latin America are connected to the United States by a strong friendship based on historical ties, shared values, and a common commitment to democracy. The United States has a keen interest in policies that promote the prosperity of all countries in the hemisphere.

We have a strong economic bond in trade linkages and in financial relations. The United States is among the top export destinations for nearly all countries in Latin America, while these countries are in turn important destinations for our exports. Latin America is also the location of investments by U.S. firms ranging from Intel in Costa Rica, to IBM, Ford, and General Motors in Argentina and Brazil. U.S. banks benefit greatly from their presence in Latin American markets, and now include two of the top twelve banks in Brazil. These linkages go in both directions, as frequent fliers in the United States know from their experience with Embraer jets. Latin American firms are also increasingly important investors in the United States, including for example, the 2001 acquisition by Brazilian firms CSN of Heartland Steel, a cold-roll steel firm located in Terre Haute, Indiana. This transaction, which allowed Heartland to emerge from bankruptcy, meant continued jobs of 175 U.S. steelworkers.

There are economic bright spots in Latin America. Chile's real GDP grew at nearly three percent in 2001, and is projected to have a decent performance this year despite a difficult global economic environment. Similarly, real GDP in Mexico grew by better than five percent annually from 1996 (after the post-crisis snapback) to 2000, before suffering from the downdraft of the U.S. recession in 2001. Costa Rica continues to attract foreign investment, in part due to their stable political system and investments in their education system—for example, Bridgestone-Firestone recently announced a \$40 million expansion of their tire manufacturing plant outside of San Jose. El Salvador, now emerging from a long period of conflict, has taken positive steps and grew at an average of 4.7 percent per year over 1990 to 2000.

But there are also countries facing a period of challenges. Argentina, in particular, faces severe economic difficulties. The crisis today is the legacy of a five-year recession in which output has fallen by 20 percent since the middle of 1998, and analysts see output falling by another 10 percent or more this year. Brazil faces challenges in fiscal and monetary policy.

Uruguay has dealt with problems, especially in its banking system, but still has a difficult road ahead.

Discussion in financial circles often centers on what actions the global community working through the international financial institutions can take to improve economic conditions in Latin America. In approaching this discussion, it must be kept in mind that the economies of Latin America are as diverse and complex as all modern economies, and that the nuances of each situation must be taken into consideration. Nonetheless, some general points can be made on the topic of the role of the international financial institutions and the considerations for economic policy.

Emphasizing the role of the international financial institutions puts the cart before the horse. To see why, it is useful to begin with the central observation that economic growth is central to creating jobs, improving living standards, and lifting people out of poverty. It is the finding of study after study that poverty is eliminated through growth. This can be seen directly in successful countries. Output in Chile grew at an annual rate of 6.8 percent from 1987 to 1998, while the poverty rate fell from 45 percent to 22 percent (though even this level remains too high). In Mexico, with the growth rebound following the 1995 crisis, the poverty rate fell from 62 percent to 46 percent of the population over 1996 to 2000. These are but two examples of the importance of economic growth for poverty reduction.

Economic growth does not appear like manna from heaven. Instead, pro-growth policies are important. Over the long term, good policies are needed to get growth. Proper domestic policy choices are not only in the direct interest of individual countries, but are essential for assistance from international financial institutions to be useful. The central economic policy issue is not how to use international financial institutions to provide assistance. Instead, the central economic policy issue facing countries in Latin America is to ensure that policies promote higher sustainable economic growth.

Free societies will always have differences of opinion about public policies. However, four general policy prescriptions can be seen as overwhelmingly important for fostering economic growth and improving living standards. These should be essential components of a pro-growth policy in any regime.

### **The Rule of Law Is an Essential Underpinning of Growth**

By this, I mean not just law and order—though this is important—but also the sanctity of property rights and the ability to make and enforce contracts. Individuals must have confidence that the government will not intervene in their legitimate private transaction by expropriating property, favoring debtors over creditors, or advantaging one sector of the economy over another in legal proceedings. Without this confidence, economic activity is stifled, and assistance from the international community will be ineffective.

In particular, efficient financial intermediation is important for economic growth, and the banking sector cannot function without the rule of law. Research has found that reforms that strengthen credit rights, contract enforcement, and accounting practices boost financial

development and thereby economic growth. A breakdown of the rule of law thus has important consequences for growth; for example, firms with good opportunities cannot get financing to undertake them. This is acutely seen in Argentina, which cannot take benefit from its exchange rate depreciation if exporters cannot get trade finance.

The current situation of the banking sector in Argentina provides a concrete example of what happens when there is a breakdown of this trust—when citizens do not trust their own government not to confiscate or freeze their savings or disregard the enforcement of their contracts. Deposits flee from a banking sector used by the government in an arbitrary fashion as a lender of last resort—or attempt to flee before they are arbitrarily corralled.

In Brazil, by contrast, the government has relied on market mechanisms in response to the challenges in servicing its debt. This trust means that deposits in Brazil have not been withdrawn from banks, a phenomenon that marked the end of the line for policymakers in Argentina. Restoring the financial system is an essential precondition for restoring growth in Argentina.

The problems in the Argentine banking system have had a direct effect on the banking system of Uruguay, where many non-residents hold deposits. With Argentine bank deposits frozen or restricted, non-residents began to make heavy withdrawals from banks in Uruguay. Hit with this large deposit outflow, Uruguay imposed a temporary banking holiday but reopened the system with international support on August 5. As part of the international support program, Uruguay has committed to take the difficult, but necessary, steps of closing unsustainable banks and strengthening the supervisory and regulatory framework and bank management in the remaining financial institutions. These steps will help to restore confidence of depositors in the banking system of Uruguay.

The banking sector cannot be secure without a stable macroeconomic environment. For this responsible fiscal and monetary policies are essential.

### **A Pro-growth Fiscal Policy Is Centered on Discipline in the Size of Government**

Extensive research has documented the poisonous effects on growth of large and growing state control of the economy. While the state should provide essential public services and ensure a social safety net, it should not enter into areas more efficiently handled by the private sector. Too often, excessive state control limits the ability of the private sector to develop the financial capacity for growth, leading to larger-than-necessary public sector spending and thus the need to raise corresponding revenues.

The problem for growth is that most taxes distort economic activity and thus impinge on growth. The key is to finance government in the most efficient way. But efficiency can run into the problem of practicality—governments must also be able to collect revenue. But this ability derives from trust—citizens must have faith that government will spend in their best interests—and this trust can be lost in a crisis.

Faced with widespread tax evasion, governments might be tempted to turn to tax schemes that secure revenue despite their inefficiency and broad cost to the economy. One such measure now in place in several countries in Latin America is the “financial transactions tax,” in which a tax is levied on withdrawals and/or deposits from bank accounts, including clearance of checks and payments of loans. The adverse incentives of this tax are obvious, in that it drives activity off the books. By doing so—that is, by reducing financial intermediation—the tax destroys the base of transactions from which it was designed to raise revenue. Because intermediation is crucial for growth, this policy lowers growth and thus the overall tax base with it. Empirical research on the deadweight loss involved in these taxes suggest that losses in some countries range as high as 45 percent.

Trade taxes can be similarly superficially attractive to a government, because the activity to be taxed is localized at a relatively small number of ports and freight yards. Here, too, the economic costs are potentially large. Import tariffs shield domestic industries from competition and thus lower efficiency, while raising costs for domestic firms that rely on imported components. This can be especially harmful for growth when the affected products might have positive spillovers such as network effects. In Brazil, for example, tariffs above 30 percent on information technology products—literally, computer networks—combine with other taxes to double costs of personal computers. It is no surprise, then, that only 4 percent of the population owns a computer, a rate lower than other emerging market countries with similar levels of GDP. In Costa Rica, for example, over 10 percent of the population own personal computers.

In addition to paying heed to efficiency, fiscal policy must be sufficiently flexible that a surplus can be run in good times and a deficit in bad times. On this point, Brazil provides an example of success, having increased its primary balance by 3½ percentage points of GDP from 1998 to 2001.

Of course, a particular value for the primary surplus is not an end in itself—economic growth is the end. A further component of a pro-growth policy agenda is to ensure that decisions made at different levels of government do not work at cross-purposes. Argentina and Brazil share the characteristic of highly decentralized political structures, with a great deal of authority residing with the provinces. In Brazil, the Fiscal Responsibility Law enacted in May 2000 has been seen as instrumental in imposing fiscal discipline across the levels of government. Among the provisions, the law creates checks on federal and provincial expenditure, and provides incentives for provinces effectively to collect their revenues or face loss of federal transfers. Indeed, initial research suggests that provincial governments and public enterprises in Brazil have contributed to the fiscal consolidation effort, with the federal government acting as a buffer to offset the impacts of the cuts. In Argentina, provincial deficits have contributed to the inability to maintain an appropriate fiscal position; indeed, it has taken months of crisis for the federal and provincial governments to come to an agreement to rein in deficits.

While anti-growth fiscal policy is at root of much of the region’s economic woes, it is linked to monetary policy. Countries have too often hobbled their banking sector by forcing it to become lender of last resort to the government.

## **Effective Monetary Control Is Vital for Economic Growth**

Individuals cannot form expectations about inflation without effective monetary policy—the resulting uncertainty depresses investment and growth. For monetary policy to be effective, it must be centralized—provincial quasi-monies such as we have seen in Argentina are simply an alternate route to inflationary financing of a profligate government sector. Moreover, it is difficult to have effective monetary control without a functioning banking sector—quantitative credit limits as opposed to market-based price signals from interest rates lead to distortions in investment decisions that hinder growth.

Central bank independence is a useful feature, particularly if this institutional separation helps the central bank to be seen as credible and free of political interference; indeed, economic research associates this separation with lower inflation and higher growth. But in the end, policy implementation is what matters—policymakers must make good decisions. As has been seen in Argentina, bad fiscal policy decisions—notably, the inability during periods of favorable growth to run fiscal surpluses and thus the steady increase in debt—inevitably leads to a situation in which even a capable and independent central bank cannot avert economic difficulties.

One signal of inappropriate monetary and fiscal policies would be a continuing need to intervene in foreign exchange and credit markets. Indeed, problems with failed exchange rate pegs are symptoms of underlying problems arising from policies which lower countries' rates of sustainable economic growth, and render debt burdens unsustainable.

## **Structural Reforms That Foster Openness and Competition Are Important**

Productivity growth allows for both increased wages and thus incomes, as well as higher profits that fuel investment and thus job creation. Policies that raise productivity growth, including policies that spur competition, are those that directly increase a nation's standard of living. This general point has a number of practical applications.

A body of economic research indicates that the privatization of state owned enterprises can raise productivity growth. Many Latin American countries have made a good deal of progress in this regard. An important caveat, however, is that it is not enough simply to privatize. It is just as essential to ensure domestic competition in the industries with privatized firms, because otherwise this could simply replace a public monopoly with a private one.

Similarly, there is a good deal of evidence that flexible labor markets are important for growth. For example, provisions in many Latin American countries that hinder firms from adjusting their labor force have been found to reduce employment—the opposite of the intended effect of policies meant to make it more difficult for firms to lay off workers. In fact, the costs of such policies are mainly borne by those already on the margins of society—the poor and the young, for example—so that policies that enhance labor markets flexibility can help to alleviate poverty and social alienation, in addition to directly raising growth.

A pro-growth strategy would similarly include efforts to do away with regulations and other obstacles facing individuals who wish to start new businesses or hire workers.

Finally, it is well known that integration with the global economy spurs competition and raises productivity. Even in emerging market countries that already benefit greatly from foreign investment, more can be done to remove barriers to investment, from the bureaucratic obstacles to those that delay import of components at the port of entry. For example, Mexico has made great strides in encouraging foreign investment, starting with the 1993 Foreign Investment Law that greatly reduced restrictions on foreign investment in Mexican firms, followed by further opening in 1996. As a result, foreign investment has more than doubled as a share of GDP, from 1.5 percent before 1993 to 4 percent in 2001.

As well as gains from openness to trade with the rest of the world, there are important gains to be had from increased openness to trade within the region. The United States has a major role to play in this regard. As President Bush has stressed, Trade Promotion Authority and trade liberalization are not just in the interest of the United States, but are important for prosperity in the entire hemisphere. The United States has a major role to play in this regard. The recent passage of Trade Promotion Authority provides a way forward for future trade agreements such as those being negotiated in the Doha Round under the auspices of the World Trade Organization, and for bilateral and regional initiatives such as the Free Trade Area of the Americas and the free trade agreements being discussed with a number of countries, including Chile and Singapore.

Among the major beneficiaries of TPA are our Latin American allies, who can increase exports of agricultural and manufactured goods and benefit from inward direct investment. Immediate benefits will accrue to Bolivia, Colombia, Ecuador, and Peru, with important duty-free access to U.S. markets in exports of apparel and tuna. Negotiating room under TPA permits rapid conclusion of a free trade agreement with Chile that could increase Chilean GDP by about one percent each year. TPA also invigorates talks for the Free Trade Area of the Americas (FTAA), which would increase market access of Latin American exports of apparel, food, and manufactured goods into North American markets. Concluding FTAA could increase Latin American GDP by more than one percent each year. Finally, TPA makes a multilateral agreement on agricultural trade more likely, with potentially important benefits for Argentina, Brazil, and Uruguay.

One might say that all of this well known, but that it constitutes an agenda for the long term, not for consideration when a country faces financial or economic crisis. Indeed, in such times, discussion often focuses on the fiscal measures a country can take service debt without resorting to inflationary financing that would undermine macroeconomic stability. A responsible fiscal policy is necessary for a country to emerge from a crisis, but this is not sufficient for ensuring sustainability. Instead, measures aimed at promoting higher sustainable economic growth are fundamental to ensuring debt sustainability over the medium-term.

One way to approach this is to consider the ratio of debt to GDP, which is of course widely used to indicate the sustainability of a country's macroeconomic program. A policy agenda focused only on the numerator—on fiscal policy—is flawed, even in the short run. An economy can face the prospect of a financial crisis on account of a near-term liquidity problem.

It can also face pressure, however, if market participants develop the belief that the medium-term program is not sustainable. It does not matter if a country has dollar reserves or a stand-by arrangement sufficient to cover its obligations for a year or more. Risk spreads will widen and interest rates will rise today if potential creditors see that slow growth will make it impossible to service debt for any reasonable set of fiscal measures. Of course, this market reaction only forces a country further away from a sustainable path.

A pro-growth policy agenda is thus essential for both preempting crises and responding to them—it is essential to look as well at the denominator of the debt-to-GDP ratio. Just as in the United States, the main causal direction is from growth to the fiscal balance and not *vice-versa*. A stronger economy is thus the appropriate target for policy, not a particular value for the fiscal balance per se.

### **Considerations for Sovereign Debt Restructuring**

Of course, even with the best of intentions, there will be circumstances when sovereign borrowers will be unable to honor their commitments. For example, external negative shocks such as a rise in oil prices, the depreciation of a competitor's currency, or a global economic slowdown, can leave a sovereign without the resources to meet its obligations even with implementation of appropriate pro-growth policies. A restructuring of the debt profile may be the policy to promote sustainable growth. It is thus important to have a framework in place to handle the situation.

The contractual approach, involving clauses in debt contracts that encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious, but orderly, restructuring of unsustainable sovereign debt is the essential first step to addressing sovereign debt restructuring. A set of model clauses can encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious but orderly restructuring. Contractual modifications could include: (1) collective representation clauses to structure discussions within creditors; (2) collective action and sharing clauses to deal with possible holdout creditors; and, (3) exit consents to encourage participation in exchanging old debt instruments for new ones.

It would also be useful to develop a way to address disputes across instruments, either through the clauses themselves or a separate mechanism. For example, this might be done through formation of a sovereign debt dispute resolution forum to address the complexity of financial instruments. Such a forum would be one way to bring together debtors and all classes of creditors, allowing development of a restructuring plan to proceed jointly with all relevant claimants. Participation in the forum could be voluntary. This forum is similar to that proposed by IMF First Deputy Managing Director Anne Krueger in the context of a statutory approach to sovereign debt restructuring. The contractual and statutory approaches could be complementary and investigated in parallel.

One consideration that is relevant for both the contractual and statutory approaches to sovereign debt restructuring is the possibility that creditors and debtors lack incentives to come to the table in a timely fashion to begin a restructuring process. A way to address this would be to provide incentives that would help avoid IFI lending into unsustainable situations. Access

incentives would not place a rigid quantitative limit on the use of IMF resources, but would instead provide incentives for countries to curb access and enter negotiations to restore sustainability. These incentives would reinforce the important idea that official financing should be complementary to restoring private-sector growth.

It is important to keep in mind that the rationale for an IFI program is to restore sustainable growth. This can only be accomplished by reviving the private sector. Economic growth allows both an improvement in the well-being of the people in the country and a greater ability to repay creditors. IFI funding thus should help to restore the creditworthiness of—and ultimately, creditor flows to—the private sector. The pro-growth agenda I discussed is fundamental to this goal. Thus IFIs should emphasize such an agenda in their programs.

In so doing, it is important to remember that the reason for reforming the restructuring process is to encourage the private sector growth and private capital flows that have benefited emerging market countries and have the potential to lift the poorest economies from poverty.

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Let me close where I began. Our ties to Latin America give the United States a strong interest in economic growth in the region. Economic growth and the progress it offers all citizens are made more likely by a policy focused on promoting growth. The essential elements of such a policy are the rule of law, fiscal responsibility, monetary control, and openness. These steps are already in the interest of in our hemisphere. Following this course also deepens ties with the rest of the world, and creates the conditions under which international assistance can be useful in times of need.