

Remarks by Governor Roger W. Ferguson, Jr.
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Latin America: Lessons Learned from the Last Twenty Years

Thank you very much for inviting me to join you this evening here in Miami. It is a pleasure to become a member of the roster of Federal Reserve Governors who have addressed this joint meeting of the Florida International Bankers Association and the Miami Bond Club.

My theme this evening will mirror the fact that international banking has grown significantly in Florida in the more than twenty years that have elapsed since the passage of the Florida International Banking Act. Many of you in the audience represent institutions that are active in trade finance throughout the hemisphere, and there is a natural strong link between Florida and Latin America. Similarly, about twenty years ago I studied Latin American economic development with Albert O. Hirschman, one of the great development economists of our time. Therefore, the topic I would like to discuss this evening is what has worked, and apparently has not worked, in Latin America in the last twenty years or so.

The main message is that, after the 1980s debt crisis, many Latin American countries embarked on a path of greater economic freedom, lessened government intervention in markets and sounder policies. Those policies provided the basis for heightened economic dynamism and growth, and thereby led to significant benefits for their citizens, including higher incomes, lower inflation, and a wider range of economic opportunities. In view of my audience today, I should also mention that, partly as a consequence of improved and more market-friendly policies, many of Latin America's banking systems are endeavoring to become more efficient, more stable, and better integrated with global financial markets. As a result, Latin American banks should become better able to support the process of stable, non-inflationary growth in the future. The current economic and financial problems in Brazil should, if anything, reinforce the importance of pursuing sound fiscal and monetary policies and improvements in the underlying institutions that support economic activity.

Background

Twenty years ago, or by the end of the 1970s, Latin America was on the verge of moving from a phase of unsustainable economic activity--based on high domestic consumption, heavy borrowing from abroad, unsustainable currency levels, and excessive intervention by government into the economy--into a decade of lost growth and lost opportunities known as the Debt Crisis. As the 1980s began, Latin American countries saw prices of their exports plunge, interest rates skyrocket, and access to international capital being cut back severely. In this harsh new environment, the shortcomings of previous policies became even more apparent, and economic performance faltered. Currency values plummeted as governments ran out of reserves, inflation soared, in some cases to as much as triple digit levels, and the output of the region contracted severely. Key social and developmental priorities had to be scaled back as governments struggled to finance their budgets and find the funds to repay

foreign creditors. Domestic financial systems were thrown into disarray and many banks were severely weakened, both in direct response to the shocks hitting the region, and also as a result of misguided government policies undertaken in response to economic and political problems. The main discussions regarding Latin America seemed most focused on issues of hyperinflation, high unemployment, and repaying the external debt.

Not surprisingly, under these circumstances, job creation during the 1980s was slow, many domestic businesses did not invest, and direct foreign investment was weak as well. These problems were not merely the result of uncontrollable, external shocks. They also reflected the fact that many governments in the region were slow to enact the reforms that would lay the foundation for future growth. In fact, in many cases governments responded to problems with policies that made things worse, not better, including wage and price controls, freezes on domestic interest rates, and adoption of protectionist trade policies. These latter were in some ways particularly problematic, in that Latin American countries in general did not focus on growing out of their problems through expansion of foreign trade. Trade flows during the period were relatively small, compared with what one might expect from economies of their size, and the trade that did occur was highly tilted toward raw materials and semi-processed industrial products.

In sum, notwithstanding some bright spots, the tone of discussion regarding Latin America seemed biased toward discussion of problems and not of opportunities.

Current Conditions

I cannot say that all of the problems of the late 1970s and 1980s have evaporated. Indeed, as is illustrated by the current situation in Brazil, there are clearly problems still to be resolved. It continues to be important for Brazil to implement macroeconomic and structural policies that restore international confidence and also reassure citizens that inflation will not re-ignite.

However, much does seem to have changed with respect to Latin America during the intervening period, and the region as a whole, even recognizing the ongoing challenges of the current situation, appears to be closer to achieving the promise that it showed a generation ago. Most of the countries in the region have experienced growth since the 1980s. Indeed, the growth rate of Latin American countries has averaged about 3-1/2 percent annually during this decade.

In addition, the scourge of inflation seems, in general, to have been brought under control. The costs were high, but the battle seems mainly to have been won. Admittedly, the worst inflation rates, at about 40 percent, are still high by the standards in the United States. However, they are much reduced from those that existed twenty years or even ten years ago. Last year, Argentina's inflation rate was under 1 percent. That is down from nearly 5000 percent in 1989!

Knowing that many of your institutions are involved in trade finance, you know that the trade outlook for the region has changed significantly from what it was a generation ago. The annual total merchandise trade of Latin American countries has grown from \$130 billion in 1978 to \$522 billion in 1997. Even adjusted for inflation, this represents nearly a doubling of its trade, allowing the growth of Latin American imports and exports to roughly match the explosion in international trade experienced throughout the world economy during this period. Moreover, in many Latin American countries, exports have grown substantially as a proportion of total production, and the fraction of these exports accounted for by manufactured goods has also increased.

Finally, Latin America has become an active participant in the flow of foreign direct investment and other forms of capital. In 1990, as the Debt Crisis was winding up, net direct investment flows to Latin America totaled only \$7 billion; by 1997, this figure had risen to \$51 billion. Portfolio capital flows also have grown very substantially. Although they have been more volatile as well, net portfolio investment rose from \$18 billion in 1990 to a peak of about \$61 billion in 1993 and 1994, and were \$34 billion in 1997 in the wake of the Asian crisis. Obviously, the current problems indicate that participation in the global capital markets requires policy discipline and sound institutional structures, which many countries have put in place and others must continue to develop.

Causes and Lessons

As with any macroeconomic performance, there are many causes for the general improvement that much of Latin America experienced since the 1980s. The most general statement is that many of the economies of Latin America have adopted more prudent and open policies that foster competition and participation in global markets. The adoption of these improved policies did not come out of thin air. They were born out of the disastrous economic performance of the region during the 1980s, and the realization that only dramatic improvements in economic policies would suffice to allow growth and prosperity to take hold.

First, there has been a general acknowledgment, and recent reinforcement of the lesson, that prudent fiscal policy is crucial to economic stability, and several of the economies of the region have made significant strides in this direction. While much is left to do in this sphere, it does appear that many countries have learned the benefits of prudent fiscal policy. Fiscal deficits in most countries in the region have dropped, and in cases where they have not yet declined, serious attention toward achieving improvements is being mustered. Improvements in budget balances have not been achieved without pain. In many countries government payrolls have been slashed, generous transfer and subsidy programs have been cut, and social expenditures have had to be reduced. On the other hand, the realization has become widespread that in the absence of such budget-cutting measures, employment and wages would become even more depressed. Moreover, people have found that many of the actions taken to cut budgets, including privatization of money-losing state enterprises, has led to better service and an improved quality of life.

Second, there has been a substantial dismantling of the controls imposed by government over private sector prices and wages. It is now widely understood that excessive budget deficits and money creation are the root causes of inflation, and controls over private prices have been generally abolished. Governments also have largely scaled back their role in private wage negotiations as well. Public controls on privately contracted interest rates and other financial market prices also have been eliminated for the most part. Finally, exchange rates in many Latin American countries have become more flexible, and where the government still intervenes in foreign exchange markets, there is a greater understanding that such intervention must be underpinned by appropriate fiscal and monetary policies.

Third, the role of the government in other aspects of the economy has been substantially diminished, with an accordingly greater scope allowed for private activity and for competition from abroad. Internally, many countries have privatized major businesses. The privatization of Telebras, the Brazilian telephone company, is a prominent recent example, and privatization has proceeded even further in other Latin American countries. Such privatization has in many cases been complemented with legislation opening particular

sectors to greater and fairer competition. Additionally, trade barriers have been removed in many countries, often through participation in regional agreements and broader international arrangements. The trade barriers that have been dismantled include both tariffs and non-tariff barriers. In consequence, the share of foreign trade in economic activity has increased substantially in certain cases. Closely associated with increased participation in international trade has been increased participation in international capital markets, made possible in part through substantial liberalization of Latin American financial markets.

Finally, in areas where government oversight is important and necessary, progress has been made in improving supervision and regulation. In particular, effort has focused on strengthening and modernizing the region's banking sectors, which emerged from the Debt Crisis of the 1980s in a highly debilitated state. In consequence, banks have gradually risen toward a higher international standard, assisted in part by an opening of domestic financial sectors to foreign competition and participation. Measured by various criteria, including capital/asset ratios and loan loss reserves, banking systems in various Latin American nations are significantly healthier than they were going into the Debt Crisis. While the region has further to go in strengthening its financial systems, and important problems remain, the progress achieved to date has been important to the overall recovery of Latin American economies in the 1990s.

Having said this, Latin America has been affected by some major international financial crises in the last several years, and obviously Brazil is being affected currently. The lessons to be learned from these crises remain the subject of strenuous debate; I would offer only the following observations. First, appropriate and balanced fiscal, monetary, and exchange rate policies continue to matter. The 1994-95 Mexican crisis and the current stresses on Brazil both indicate that markets watch closely countries that allow imbalances to emerge. In fact, in an era of open capital markets and rapid capital mobility, the punishment for policy mistakes arguably is even more rapid and severe than has been the case in the past.

Second, it may not be enough for countries merely to avoid excessive budget deficits or high inflation. Countries must take steps to reduce their vulnerability to dislocations in the international financial system, including by raising domestic saving rates, reducing excessive levels of short-term debt, and increasing the degree of transparency and disclosure both in the public and private sector.

Third, a healthy banking system is an integral part of participation in the modern financial environment, and also is a particularly important buffer against future financial shocks, both domestic and external. The question becomes how best to acquire such a system. Some countries have attempted to maintain a closed national system and build skills at home. Others have opened their banking market and allowed foreign competition to force the pace of modernization. In practice, the development of banking sectors is likely to involve some combination of local and foreign input, although increasingly, countries appear to be finding that foreign involvement provides important infusions both of expertise and competition. As well, countries are discovering a strengthening of the systems of banking supervision and regulation to be an indispensable part of the process of modernizing the financial sector.

Open Questions

Many questions about how best to manage economies in an international setting are still open. The first question is what is the best way to enter the modern world of rapid capital mobility. Foreign capital obviously can be of tremendous benefit in helping economies to modernize and grow. At the same time, the tendency of foreign investors to pull their capital

out of a country at the same time, as has recently been observed in various instances throughout the globe, can leave an economy in serious trouble. How can the benefits of foreign capital flows be retained while their adverse side-effects are minimized? Some observers have pointed to the Chilean experience with capital controls. These controls, which have now been removed, were intended to discourage inflows of short-term capital, and along with measures to strengthen the banking system, may have helped to insulate Chile's economy from the recent round of financial disturbances. The jury is still out on whether such controls might be appropriate for other economies. It seems clear that their principal attraction is as a short-term measure that helps an economy make a full transition to a fully open capital market.

A second question is whether fixed or more flexible exchange rate regimes are more appropriate in an era of rapid capital mobility. In principle, more flexible exchange rates allow economies to adjust more easily to changes in international economic and financial conditions, while fixed exchange rate systems may be useful in instilling a greater degree of discipline on the part of economic policymakers. In practice, the experience of the past year and a half has taught us that systems in which exchange rates are only half-heartedly fixed--that is, where fiscal and monetary policies are not geared toward supporting the currency--are the least sustainable and hence the least desirable. On the other hand, regimes in which economic policies are rigorously focused on maintaining an exchange rate peg may still have value in motivating prudent economic policies and in insulating economies from international financial turbulence. However, fixed rate foreign exchange regimes and currency boards require considerable internal discipline to work as intended. The benefits are potentially large, but the effort to maintain such a system and the risks associated with having to abandon such a system under duress are also large.

Conclusions

To summarize, much of the story of the evolution of Latin American economies in the past decade has been a story about globalization. Globalization has operated on many different levels to improve the performance and productivity of the region. However, participation in the global financial market does, as we have seen, entail risks for countries that have not followed prudent policies. On balance, globalization clearly has been a strong positive force in the region's economy. Latin America's economies are sounder, more entrepreneurial, and more dynamic than they have been in many decades. And yet, grave problems remain. These include widespread poverty, tremendous disparities in wealth and income, and a level of per capita GDP that in many countries remains little higher than it was in the early 1980s. I believe that these problems are more likely to be resolved through continued participation in the global economy than by falling back on earlier models of economic development.

In closing, since I am speaking to a group of bankers, I would like to reiterate the importance of good banks and good banking skills in contributing to the economic prospects for the region. By facilitating trade finance, providing funds for growing companies, and integrating domestic financial sectors into the global capital market, banks have played a key role in furthering the development of the Latin American economies. Latin American banking systems, benefiting in large part from rising levels of foreign participation, are providing increasingly competitive levels of credit and depository services, thereby laying the groundwork for future dynamism and growth. Healthy banking systems also are crucial to promoting economic stability. The recent experience of several Asian countries, where severely weakened banking systems helped contribute to financial crises, has reminded us that good banking skills and strong bank supervision are indispensable.

Albert Hirschman's wish for Latin American development, which is captured in the title of his book, *A Bias for Hope: Essays on Development and Latin America*, may eventually be fulfilled if the region stays the course and pursues sound fiscal and monetary policies and the needed improvements in underlying economic and financial institutions. Thank you.

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