Growth and Reforms in Latin America:
What Do We Know?
What Do We Need to Know?

Center for Global Development

Liliana Rojas-Suárez
Center For Global Development
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The Economic / Political Pair that Distinguishes Latin America

On the Economic Side: Open Capital Accounts combined with shallow domestic financial systems

On the Political Side: Solidifying Democracies

The Combination of these two factors imposes constraints on the policy / reforms choices for sustainable growth

The Constraints Imposed by an Open Capital Account and a Shallow Domestic Financial System

- Following an adverse shock that exposes a macroeconomic inconsistency country risk rises quickly.
- Highly liberalized capital accounts in Latin America allows for rapid financial arbitrage to take place (from high spreads on external debt to domestic interest rates)
- Private sector debt is a contingent liability of the government. Thus, it is difficult for investors to distinguish between government risk and private sector risk. Hence, adverse shocks increase the perceived risk of liabilities issued by the public <u>and</u> private sector, pushing domestic interest rates up.
- Because the financial system in the region is dominated by short-term instruments, domestic interest rates at all maturities are affected.

The Constraints Imposed by an Open Capital Account and a Shallow Domestic Financial System

– Given the limited supply of domestic sources of finance in the region, the transmission mechanism of default risk into domestic interest rates is exacerbated. This is valid even in a flexible exchange rate system because even a large exchange rate depreciation cannot generate external resources quickly enough to offset a significant reduction in external sources of finance.

The Constraints Imposed by an Open Capital Account and a Shallow Domestic Financial System

Thus:

- Macro Inconsistencies leading to a deterioration in the perception of country risk severely and quickly affect economic growth.
- Lacking a diversified export based, fixing or manipulating the exchange rate is a “risky business” in the region. **Latin America cannot play the China game.**
- To an important extent, Latin American’s sequencing of liberalization was not conducive to growth

The Political Constraint:

The increased participation of the population in the political processes has resulted in an increased demand for access to the benefits from modernization and growth.

This imposes important constraints on the design of key reforms: such as the labor reform

The Foundations for Growth in Latin America: Three "Classics" Plus Two Regional

- Secure Property Rights
- Equality of Opportunities
- Sufficient Economic and Political Competition to Avoid "elite" capture of the State.

- Macroeconomic Stability
- Broad sharing (among the population) of the benefits from growth.

The Questions Asked by the CGD Task Force

1. What "breaks" the link between reforms and growth?
   - **Problems of relevance:** Ex: Implementing Pillar I of Basel II might be counterproductive

The Questions Asked by the CGD Task Force

1. What "breaks" the link between reforms and growth?
   - **Problems of design:** The reform did not create the incentives to impact positively on one or more of the foundations for growth
     - Technical Inadequacies
       - → Ex: Pension fund reform in Bolivia
     - Lack of appropriate sequencing
       - → Ex: Liberalization without adequate regulation in place
     - Lack of complementary reforms
       - → Ex: Adequate budgetary institutions need to complement a decentralization reform

The Questions Asked by the CGD Task Force

1. What "breaks" the link between reforms and growth?
   - **Obstacles from Local Constraints:**
     - **Institutional Constraints**
       → Ex: Privatization of telecommunications in Peru: Lack of independence of regulatory agency leading to capture by the government.
     - **Political set-up**, including lack of legitimacy of the reform, that allows for the dominance of certain political interest
       → Ex: Trade reform in Brazil
     - **Implementation Capacity**
       → Ex: Decentralization
     - **Inequality of income, assets and education**
       → Ex: Lack of participation in the private pension fund system by the large segment of "informal" workers in Peru

The Questions Asked by the CGD Task Force

2. How can Obstacles be Overcome?

A few answers:

A. Dealing with Problems of Design:

- Hedge against external shocks by taxing commodity exports in boom periods to finance incentives for local exports diversification and innovation
- Implement ex-ante loan loss provisions to improve the quality of banking systems
- Do not mimic the tax mix of industrial countries. Instead, take into account the importance of the informal sector.
- Proper design of a budgeting institution needs to introduce transparency rules at the same time that numerical rules are introduced

The Questions Asked by the CGD Task Force

2. How can Obstacles be Overcome?

A few answers:

B. Dealing with Obstacles from Local Conditions:

- A most difficult problem where some forces of “market discontent” can help. For ex: those whose slogan is:
  - “Down with corruption” (Pro-transparency forces)
  - “Down with Inequality” (Pro-access Forces)
  - “Multiculturalism starts at home” (Identity promoters)
- Country differences stand out significantly

An Example of Making Use of What we have: Putting Pension Funds to Work (for Growth)

The Facts:

Assets of Pension Funds (as % of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
ARGENTINA	3.0	3.9	5.9	7.2	7.7	11.7	12.5	12.0	12.3
BOLIVIA	1.2	3.9	6.4	10.0	11.5	14.4	18.3	19.6	22.0
CHILE	36.9	38.8	47.3	47.7	51.7	52.8	67.4	64.0	64.8
COLOMBIA	1.3	2.1	3.3	4.3	6.0	6.8	9.2	11.4	13.1
COSTA RICA					0.1	0.8	1.7	2.6	3.6
EL SALVADOR	0.0	0.4	1.7	3.7	5.8	7.7	10.4	13.6	17.1
MEXICO	0.2	1.4	2.4	2.9	4.4	4.9	5.6	6.3	7.2
PANAMA						3.7	3.6	3.5	3.3
PERU	2.6	3.1	4.7	5.2	6.7	7.9	10.3	11.3	12.0
URUGUAY	0.9	1.7	2.8	4.0	5.6	7.4	11.0	12.6	12.8

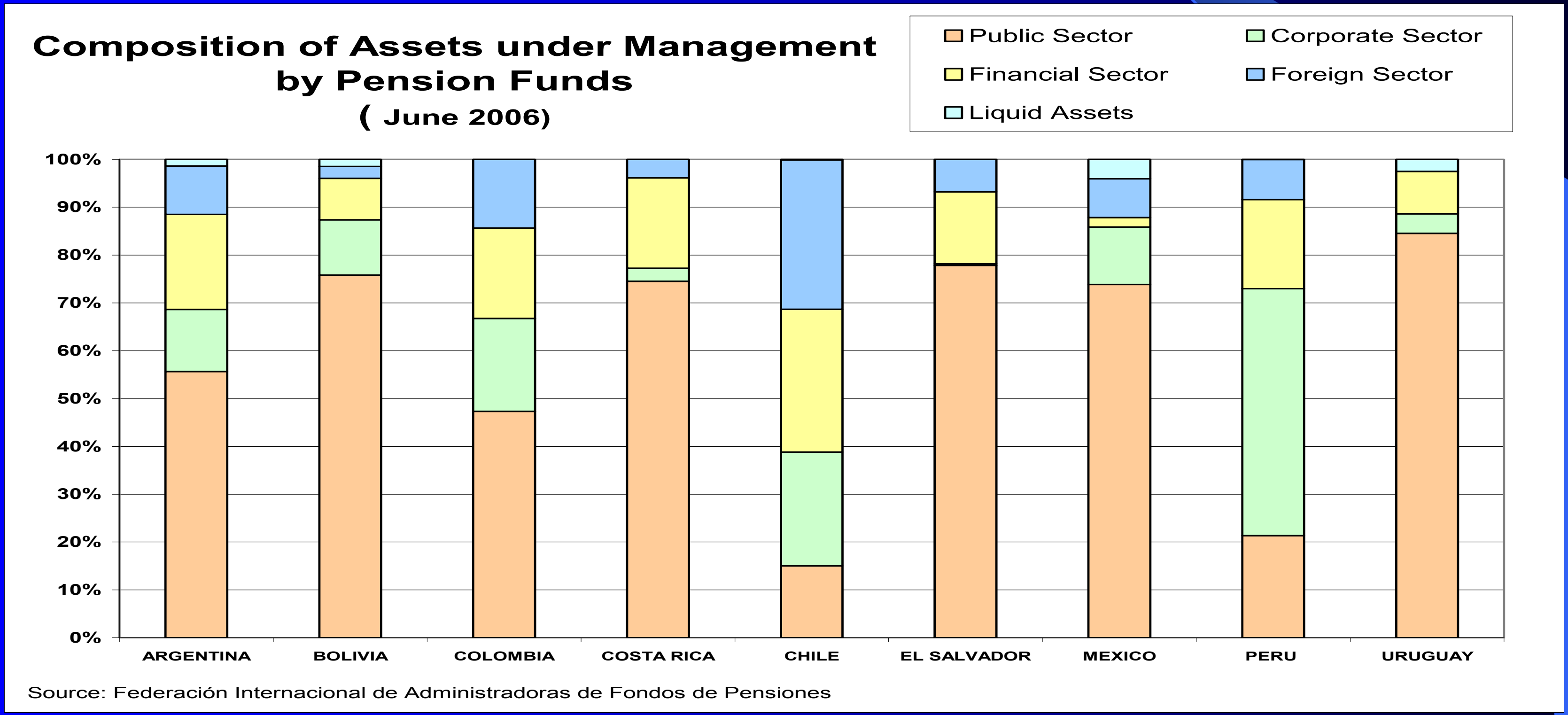
Source: Federación Internacional de Administradoras de Fondos de Pensiones (FIAP), IMF

It is estimated that, by 2015, in many countries in the region, the accumulation of assets by pension funds will reach over 30% of GDP (the current average ratio of deposits to GDP in the region)

An Example of Making Use of What we have: Putting Pension Funds to Work (for Growth)

The Facts:

But, regulatory restrictions combined with shallow capital markets have resulted in pension funds' portfolios tilted towards public sector debt (with the exception of Chile and Peru)



In some cases, like Mexico and Uruguay, government bonds reach over 80 percent of pension funds' assets

An Example of Making Use of What we have: Putting Pension Funds to Work (for Growth)

The Recommendations:

- Pension funds need to be allowed to hold more diversified portfolios. However, concerns from local policymakers are understandable. For example, allowing free investment in foreign assets in countries that have not reached macro stability might exacerbate capital outflows
- If macro stability is achieved, pension funds should be allowed to invest in instruments which in some cases may not be publicly offered or traded in exchanges, <u>provided that adequate disclosure and operational transparency allow for appropriate external auditing.</u> (see = www.claaf.org)

The reality of corporate structure in Latin America is quite different from that in industrial countries. Firms in Latin America are mostly small, privately-held, family-owned. Thus, issuing securities is subject to higher fixed costs (relative to bank loans).

An Example of Making Use of What we have: Putting Pension Funds to Work (for Growth)

The Recommendations:

- To cater the investment needs of the region in a way compatible with the pension funds' return and safety goals demanded by citizens, the development of the following asset classes is recommended (which exists only in some countries to a very limited extent):
  - Securitized bonds based on the pooling of receivables such as farm crops, livestock breeding, future flows of university tuitions, etc.
  - Infrastructure finance bonds, with long-term duration and local currency denomination (attractive for pension funds). Ex: Chile.
  - Collateralized Loan Obligations (CLOs), which effectively transform risky loans (say, to SMEs) into a combination of investment grade assets well suited for pension funds and high risk assets suited for other investors.