Lecture 10
Rebuilding the Latin American Consensus

Domingo F. Cavallo[1]
Harvard University, Cambridge, Massachusetts, U.S.A.
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From the end of the eighties to the end of the nineties a consensus on how to reorganize the national economies of the region emerged in Latin America. Although the establishment in Washington and its critics like to call it "the Washington Consensus", I contend it was a true "Latin American Consensus" generated by the exhaustion of the import substitution growth strategy and the lessons of the debt crisis of the eighties.

Although the reorganization of the economies was implemented with varied degrees of coverage and deepness in different countries, today Latin American economies have in common some important features that significantly contrast to the kind of economic structure and organization present in the mid eighties.

As a matter of fact, most Latin American economies have been able to cure chronic inflation, erosive stagflation and virulent hyperinflation, three related diseases that in different doses had infected the region until the early nineties. The success in fighting inflation brought about the necessary popular support for the accompanying reforms, at least at the time the reform packages were launched.

Nowadays, most Latin American economies can show increased private sector participation, more competitive markets, and smaller public sectors, which besides function under stricter budget constraints.

Finally, most Latin American economies are today both more open to foreign trade and investment and have received, at least for some years, larger inflows of foreign capital than in previous decades.

Chile is the only one economy that reached rapid and fairly stable growth. Argentina reached also rapid growth in the early 1990s, which lasted eight years, afterwards it went into a very deep crisis and its economy now looks completely disorganized. Brazil and Mexico looked a bit more institutionally stable than Argentina, but their growth performance since the beginning of the nineties was mediocre at best.

Except for Chile, in most other Latin American economies, income distribution worsened and extreme poverty not only did not diminish, but even also increased. As a consequence, democracies are weakening and governments face increasing difficulties to maintain popular support for the policies they choose to implement, no matter their ideological tint. The political picture is completely opposite to that that emerged at the beginning of the reform processes, when governments were able to defeat inflation.

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Those that argue that the direction of the reform process implemented by the Latin American Consensus of the nineties was fundamentally wrong propose a reversal of the reforms. If this opinion prevails there will be increasing Statism and Isolation and that trend will sooner or later reintroduce inflation in the economies. The social consequences will be even worst than those of the previous reforms.

I sustain that the direction of the reforms embodied in the Latin American Consensus of the nineties was right but in many countries the reforms were incomplete and superficial, particularly in its intent to increase and mobilize domestic savings and to open investment opportunities accessible to all kinds of entrepreneurs, not only to the old and big firms. They were also incomplete and superficial in relation with the planning and operation of the public sector that in most cases did not focus its effort in providing security, justice, education and public health.

The Latin American Consensus of the nineties needs to be reborn and rebuilt. It should be revived in its commitment to reform both the Market and the State. But it should also be rebuilt in the sense of emphasizing the inclusiveness of the Market and the transparency and democratization of the State.

Market reforms for more inclusive growth

The key for making growth more inclusive is to reorganize the markets through the simplest and clearest rules possible rather than through discretionary interventions of the State on a case-by-case basis.

Monopolies created and enforced by the State should disappear and natural monopolies should be regulated in such a way that the risk of the capturing of the regulators by the monopolists is minimized.

Further privatizations should only be conducted after the monopolies have been broken or effective regulations have already been enacted and the agencies responsible for enforcing them are able to operate with exclusive focus in the general interest of society. That is to say, the appropriate checks and balances for the well functioning of the natural monopolies should be in place, before starting a new privatization wave.

Tax and labor regulations should be simple and minimal for the new and small enterprises, as to encourage entrance of the informal businesses into the formal economy.

The registration of assets and the protection of the property rights of those operating previously in the informal economy should be the backbone of the strategy to include the maximum number of workers and small proprietors into the formal market economy.

The use of electronic and plastic money and the facilities offered by the Information Technology make it possible a rapid process of formalization of the informal economy that could not have been imagined just ten years ago.

Credit should be available not only for the old and big businesses but also for all households and the new and small enterprises. This will only happen to the extent that the process of formalization of the informal economy takes place simultaneously with an effective process of mobilization of increased domestic savings and with a financial intermediation system that encourages domestic lending of the available financial resources.

A tax system based on a uniform Value Added Tax, a progressive Personal Income Tax at the Federal level, and Sales and Property Taxes at the local level should generate the tax revenue necessary to finance government expenditures.

The Government Budget should be balanced over the business cycle making room for deficit financing at times of recession with the cumulated surpluses during the boom years.

Macro policies, mainly fiscal policy, will be available for dampening the business cycle only if the country is able to accumulate financial wealth during boom years.

Monetary policy will only become a counter cyclical policy tool once the currency is trusted by the people. For that to happen it may take a long period of time if the economy has a long experience of inflationary outbursts.

Monetary Regimes in Latin America

There is no such a thing as an optimal currency regime for Latin American economies. As it usually happens in relation to most political and economic institutions, the best rules of the game depend on every country specific historical circumstances. The best that theory can do to help institution building in emerging economies is to point out the risks associated with the acknowledged distortions in each type of second-best solution.

A currency regime is an essential part of the institutional base of any economy. If an emerging economy is unable to create a good currency regime, it will lack the financial and capital markets that are essential for the financing of productive investment. With those limitations it will be difficult for such an economy to simultaneously achieve stability and growth.

A good currency regime has to provide at least one currency to efficiently fulfill the following roles: a means of exchange for every kind of market transaction (spot, future, domestic, foreign) and a store of value. No doubt, the best currency regime for a national economy is that of the US today or that of the UK at the time of the British Empire. One currency, the Dollar today (or the Sterling prior to WWI) is accepted worldwide for every kind of transaction and is considered a secure store of value. Nowadays, only Europe, as a Monetary Union and eventually Japan if it finally decided to internationalize the Yen, are in a position to create such a currency regime. In the three cases, the currency permits the existence of spot and future markets of every imaginable kind, while long term interest rates are close to some concept of a ”natural rate,” reflecting long term expectations of price stability.

To open the door to the best solution for emerging economies, a future International Monetary System should offer them the opportunity of becoming full members of a monetary union that will meet the conditions identified by Nobel Laureate Robert Mundell for optimum monetary areas.

Nowadays, countries, which are eligible to become members of the European Union, enjoy the prospect of joining the euro. However, this is not the case for emerging economies that mostly trade with the US or Japan, because none of these two leading nations have demonstrated any intention of letting their national currency regimes evolve into larger Monetary Unions. In an ideal world, a good way to move in the direction of building a better International Monetary System that would increase the prospects of stability and growth for the global economy, would be to have the US and Japan demonstrate a willingness to use their currencies as the base for enlarged monetary unions that would offer to their developing country commercial partners the possibility of adopting the best possible currency regime. Yet, so far, the re are no signals that the US and Japan endorse the idea.

The second best currency regime for emerging economies would involve the use of a domestic currency different from those used in foreign transactions, or simply adopting the Dollar, the Euro or the Yen for domestic transactions. Countries will find significant advantages in using one of the three above mentioned foreign currencies in domestic transactions if two conditions apply: they trade heavily with one of the three monetary areas; and a long history of inflation has prevented the creation of future markets and long term financial contracts. Foreign currencies such as those previously described will dominate inflationary expectations and will allow for the creation of future markets that cannot develop in an inflationary environment.

This means that long-term interest rates will be much lower than otherwise. The one important constraint emerging economies may need to cope with relates to the lack of a central bank that may act as a lender of last resort. Notwithstanding, the relevance of this limitation deserves further analysis given the fact that whenever the domestic currency is not credible enough, a central bank' chances of providing lending of last resort is very limited. In such a context, when a financial crisis looms there is usually demand for the foreign currency. Thus, increasing the supply of the domestic currency only feeds hyperinflation. This explains why Panama, Ecuador and El Salvador have already adopted the Dollar as their currency, and why it is likely that other economies in Central America and the Caribbean pursue the same course in the future.

When the "second best" currency regime, so to speak, includes a domestic currency, the economy involved has to define two main features: the degree of convertibility between the domestic and the foreign currency, and the degree of flexibility of the rate of exchange. In case that the financial history and behavior of the country allows it to have a currency regime that combines the maximum of convertibility with the maximum of exchange rate flexibility, then there is no doubt that that particular economy should choose full convertibility and a free float for the national currency. The UK, Switzerland, Canada, Australia, New Zealand, Singapore and a few other economies chose that path long ago.

The typical dilemma for an emerging economy that has had a long experience of persistent inflation, and even worse, hyperinflation is how to deal with the trade off between convertibility of the domestic currency and flexibility of the exchange rate. The degree of convertibility needs to be somewhat restricted so that the Central Bank has some capacity to conduct an independent monetary policy through the flexibility of the exchange rate. Otherwise everybody would use the foreign currency for most domestic transactions, particularly those involving long-term contracts. The typical restriction to convertibility that is commonly imposed involves prohibiting financial institutions to accept foreign currency deposits from residents and prohibiting residents to lend domestically in the foreign currency. In economies that have long been exposed to periods of inflation this limitation to convertibility may generate the flight of domestic savings. Hence, the constraint is normally accompanied by some additional restrictions on the transfer abroad of residents' funds.

These restrictions may impose significant distortions on the economy, particularly if residents interpret them as the government leaving the door open for the imposition of a future capital levy through sudden devaluation and inflation. These distortions will be reflected in high long term interest rates or simply the inexistence of long term savings and financing. This is one of the reasons why some emerging economies may prefer, at least for a while, to sacrifice exchange rate flexibility but to grant full convertibility to their domestic currency by managing it through a currency board. This was the case of most economies in the world between 1870 and 1930, at the time of the Gold Standard, as well as Malaysia and Singapore immediately after independence, Argentina from1991 until the end of 2001, and Hong Kong from 1983 to the present.

The challenge is, however, to minimize the risk that the sacrifice of exchange rate flexibility in favor of full convertibility end up in the catastrophic way that it did in the case of countries participating in the Gold Standard in the thirties and of Argentina in 2002. The emerging economies that choose full convertibility should exit the fixed exchange rate as soon as a persistent inflow of foreign capital calls for an appreciation of the domestic currency. That should be taken as an indicator that the economy is ready to combine full convertibility of the currency with free floating of the exchange rate. This is what Singapore did in the early 1970s.

Full convertibility, however, is not always the most convenient solution. Emerging economies that have had a history of inflation but at the same time consider it too risky to sacrifice exchange rate flexibility, particularly if they are prone to suffer severe external shocks, should probably try other institutional arrangements in order to lower long term interest rates and encourage medium and long term savings and financing. Chile, and to some extent Brazil and Mexico, have successfully used financial indexation as an alternative to full convertibility. Notwithstanding, whatever the mechanism used to remove the distortions created by the lack of full convertibility, crises will be unavoidable if there is not enough fiscal discipline, particularly, in the case of emerging economies that have a long history of inflation.

Trade liberalization and economic integration

National economies should actively negotiate removal of trade barriers within the WTO and should not make unilateral concessions unless they are necessary to generate significant welfare gains within the national economy.

Regional integration should only be pursued to the extent that it is part of a project of political and economic integration soundly grounded in geography and history and supported by the people.

In any case, regional integration processes should emphasize physical integration and include at least some minimal doses of monetary and financial coordination as to avoid sudden monetary and financial disruptions of trade and investment flows.

If the level of productivity and income of the involved countries is initially very different, resource transferences oriented to facilitate the process of economic and social convergence should be negotiated.

Reform of the State

So far, the main reforms of the State that took place in most Latin American Economies consisted mainly in a downsizing of the Public Sector associated with the process of privatization of state owned enterprises, the change from a pay as you go system to a capitalization Social Security System and the end of the inflationary financing of Public Sector deficits by Central Banks. These reforms, even though were not always implemented in the best possible way, did help to increase the degree of transparency and accountability of the State.

But many more reforms are needed, particularly in countries with a Federal System. The reforms implemented in the Central Governments were not always accompanied by similar reforms in the provinces or local states, and when these could get access to bank credit or external financing they contributed to the process of unsustainable indebtness in a way that made fiscal policy completely pro-cyclical. This was particularly the case in Brazil and Argentina. So reforms that introduce transparency and accountability in local governments are very necessary.

In some countries significant portions of the Judiciary, the Police and the Armed Forces have been captured by organized crime or have been made part of "organized corruption". There are some evidences that even though the old style corruption associated with rent seeking in closed economies and obscure management of state owned enterprises was reduced, at the same time, "organized corruption" associated with the management of social programs and the security or defense forces was increased.

The corruption of the security and defense forces is probably associated with the aggravation of drug traffic. The aggravation of corruption in the organization and management of social programs is a consequence of the shift in the composition of the sources of financing of obscure politics: as the state owned enterprises reduced their role as suppliers of funds, social programs took their place, with the terrible effect of discrediting the mechanisms that should provide social safety nets for the undesired consequences of economic reforms.

The main deficit of the Latin American Consensus of the nineties originates in its almost exclusive economic focus when the democracies of Latin America were still very imperfect and needed at least as much reform as that of the economies of the region. I consider Roberto Mangabeira Unger's proposal for a re-energized democracy very relevant and creative, but they would not work if the economic reforms of the nineties were reversed.

A reversal of the economic reforms of the nineties, for example the re-nationalization of privatized state owned companies and the closing of the economies will not help but endanger the process of political democratization of Society and the State, because it will only recreate old Latin American corporate state politics, which was even worse than the still very imperfect liberal politics of today. But a deepening of the reform in the direction of making them more socially inclusive could help a lot to make democracy more effective in removing "organized corruption" from the institutions of the State and broadening the participation of the people in political and economic development.