

RECUPERACIÓN ECONÓMICA, GLOBALIZACIÓN Y NUEVA ARQUITECTURA FINANCIERA INTERNACIONAL

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Con un gran gusto acudo a esta Reunión de la Asamblea General de ALIDE.

Agradezco la amable invitación de Rommel Acevedo y de Ricardo Palma la cual me permite estar con ustedes en este esplendoroso lugar y abordar un tema estratégico para el desarrollo económico y social de nuestra región.

Mi español va progresando por buen camino, pero espero no exista inconveniente de que, en esta ocasión, realice mi exposición en inglés.

Reforms Adopted and Frustration Sentiment

Disillusionment with structural reform has come at a time when some Latin American economies are stagnating or even shrinking. Many say this proves that reforms have failed. The most careful analysts, however, say that the jury is still out, at least until reform's effects can be distinguished from other factors that may be hurting the region's economic performance.

Reform's heyday came in the early 1990s, when profound measures to liberalize trade and financial markets were enacted throughout the region. In tax and labor reform as well as privatization, however, efforts were far more modest. The pursuit of privatization was especially uneven: Bolivia, Peru, Brazil and Argentina have gone a long way toward privatizing their public utilities, while Uruguay, Paraguay, Costa Rica and Ecuador have barely begun to do so. Labor market reform has been limited to a few countries, and has nowhere been extensive. Reform as a whole has slowed in the last few years, especially in Argentina (since the beginning of its debt crisis in December 2001) and in Venezuela.

Until few years ago, the prevailing view of reform's effects was optimistic. Estimates based on data gathered through about 1995 seemed to show that the reforms had boosted annual growth rates by an average of about 2 percentage points per country across the region. More recent research, however, has found that the growth effect was actually about half that level, and that the growth boost was a one-time effect that kicked in after the reforms were implemented, but then faded. While controversy continues to swirl, it seems fair to say that the effects of reforms differ from place to place depending on the precise mix of policies that were adopted, and on how they were put into action. Countries where the rule of law prevails and where public institutions are strong enough to support legal and regulatory change are also lands where reforms have been most effective in raising growth and incomes.

Leaving aside the question of tax reform (where inherent difficulties in measurement hamper research) the best current thinking on the effects of the different types of structural reforms might be summarized as follows:

Trade Reforms. Numerous studies using both cross-country and in-depth analyses of country experiences have found a positive correlation between trade openness and economic development. To some extent, NGOs, anti-globalization activists, and economists, who have criticized free trade, are currently challenging these results.

Financial Liberalization. The basic aim of financial sector reform is to improve the efficiency and soundness of a country's financial system by eliminating the distortions that come from interest rate controls and other such nonmarket mechanisms for allocating capital. Country studies for Ecuador, Mexico, Chile, and Indonesia indicate that financial liberalization has indeed eased credit constraints and led to more efficient uses of capital. Yet countries that have rushed into liberalization without proper legal, regulatory, and supervisory structures have risked post liberalization crises that have triggered fiscal instability and surging unemployment. Note, however, that liberalizations *per se* are not the causes of crises. Problems have resulted when the liberalization was implemented incorrectly.

Privatization. The analysis of the costs and benefits of privatization suggests that private firms clearly outperform public firms in competitive markets, but that there is a role for state-owned enterprises in sectors characterized by a natural monopoly. Given that state-owned enterprises can correct market failures, one would expect that the advantages of public enterprises are greater in developing countries, where market failures are more pervasive than in developed countries. The empirical evidence, however, seems to suggest that the opposite is true. A survey of 52 studies of the impact of privatization on economic efficiency and welfare found that 32 studies concluded that privatization is welfare-enhancing, 15 studies found an ambiguous effect of privatization, and five studies found a negative effect of privatization. However, none of these five studies focused on developing countries. It is worthwhile emphasizing that a successful privatization also requires the establishment of proper regulations to control monopolies in the provision of utilities.

Labor Reforms. Economic theory suggests that labor market regulations meant to protect workers against the risk of unemployment, old age, and sickness may also inhibit labor market efficiency and the development of labor-intensive activities. The empirical evidence supports the assertion that provisions that increase the cost of dismissing workers reduce labor flows across jobs and between employment and unemployment. The effect of job security provisions on total employment is, however, uncertain. On the one hand, it has been found that reducing job security provisions increases the probability of job loss and unemployment. On the other hand, job security provisions reduce the probability that unemployed workers will find a new job.

Growing evidence also shows that job security provisions alter the distribution of employment, with greater adverse effects on the young and groups marginal to the workforce. As a consequence, labor market deregulation can increase equality among demographic groups, though perhaps without doing much to boost total employment or output.

Economic Reforms, Poverty, and Inequality. While most economists agree that structural reforms tend to increase average income, critics counter that the reforms have malign distributional consequences and generate patterns of economic growth that benefit only the wealthiest. In response, reform's supporters argue that these measures (especially trade openness) increase growth without causing big changes in income distribution. Therefore, these authors conclude, that the increase in average income brought about by economic liberalization is largely translated into increased income for the poor. While there is some evidence that, *on average*, growth is distribution-neutral, a look beyond the averages reveals

large differences among countries with regard to how greatly growth benefits the poor. In particular, Martin Ravallion points out that the drop in the poverty rate brought about by a 1 percent increase in the growth of average household income can range between 0.6 and 3.5 percent. Other studies have shown that the rate of post reform income growth among the poor is considerably lower than the average rate across all society. This seems to indicate that while reforms can help to relieve poverty in an absolute sense, they could also act in a relative sense to worsen income inequality.

There is also evidence that structural reforms may lead to rising joblessness in the short term. While in the case of trade reforms, employment losses are reabsorbed in the medium and long run, the effects of privatization are much more difficult to evaluate. There is evidence that workers retained by privatized firms enjoyed increases in real wages (with larger gains for blue-collar workers than for white-collar workers). Yet privatizations have also indisputably led to the dismissal of large numbers of workers. Studies of Turkey and India have found that laid-off workers have suffered substantial welfare losses, with many moving into the informal sector and earning less than a third of what they once did. Thus far, there are no wide ranging studies of what has happened to workers that were laid off by newly privatized firms in Latin America.

It is fair to conclude that while several empirical studies have found that pro-market reforms do increase growth and productivity, increase has been lower than expected and have not benefited all social groups equally. After more than a decade of economic reforms, the lessons learned can be summarized as follows:

- First, For bettering the lot of the poor, structural reforms are a necessary (but not sufficient) condition because poverty alleviation requires economic growth and reforms are positively correlated with growth.
- Second, Structural reforms are not enough to raise average incomes to levels comparable to those of the developed countries within a few decades. Half a decade ago the Inter-American Development Bank estimated that by completing the process of structural reform, Latin America could increase its growth rate by anywhere between 1.2 and 1.7 percentage points. If we add this to the average per capita growth in the last decade of 1.5 percent, we obtain a growth rate of around 3 percent. Even at this rate (which successive research suggests is overly optimistic), it would take the region 50 years to reach an average level of per capita income similar to that of the OECD countries.
- Third, Pro-market reforms can and do fail. Amid unstable capital flows and terms of trade, capital account liberalization can generate instability; especially if the government's regulatory efforts and macroeconomic policies are faulty. Reform of the international financial architecture is needed as well to limit financial contagion and sudden stops in capital flows.
- Fourth, Institutions matter. Reforms (especially financial reforms and privatization) are more effective when backed by good public institutions. Good institutions keep transaction costs low and so facilitate market exchanges; institutions help solve collective action problems; and good institutions set up incentives for people to focus on productive activities rather than distributional conflicts.

- Fifth, There are *no* “*one-size-fits-all*” reforms. Economic reforms must be adapted to local conditions. Reforms that are imposed from outside and transplanted without taking into account local conditions may destroy institutions that generate mechanisms of social identification and social protection.
- Six, Growth is not the whole story. Any evaluation of structural reforms must also consider their equitableness and other social implications. Policymakers should treat the well-being of the poor as a special concern, and should realize as well that reforms that do not reduce inequality and improve social indicators will generate discontent and prove unsustainable.
- and finally, The reform agenda must be widened, and pro-market reforms merged with social reforms aimed at fighting economic vulnerability, poverty, exclusion, and inequality. These two kinds of reforms need to be integrated not only for the sake of political sustainability but also because they tend to reinforce each other, and there is evidence that inequality is harmful to growth.

On this last point of inequality let me recall that countries in Latin America are among the most unequal in the world. In the late 1990s, the wealthiest 20% of the population received some 60% of the income, while the poorest 20% only received about 3%. The region's high levels of inequality and poverty trace their origin to inequities in the distribution of assets, particularly education and also in the unavailability of productive resources particularly financial.

A return to high growth rates is crucial for poverty reduction. It is estimated that the region will need a yearly growth of 4% in per capita terms to reach the millennium goals of halving poverty by 2015, a difficult task given the rates of growth experienced in the 90s.

Focusing on the productive and financial sector, which is the core of this paper, the existence of market opportunities for products and services constitutes a powerful incentive for productivity gains and increased competitiveness. Access to financing of companies and individuals represents a crucial obstacle to take advantage of business prospects and direct savings to efficient use.

In financial sector development, the region presents a mixed scenario with respect to other parts of the world. The recently released 2003 Global Competitiveness Report shows that countries like Chile, Mexico and Brazil score above the world average in terms of financial market sophistication, access to credit, and soundness of the financial system. However, many other countries of the region are rated well below the world average in several areas. In addition, Latin American and the Caribbean need to perform well above the world average to close the gap with the rest of the world. Therefore, the challenge for the region is how to grow faster and in a more balanced way.

Let's review in the next sections the trends on international financial markets, and the impact on the region.

Economic Reforms and Financial Vulnerability in Globalized Markets

As discussed previously, one of the major frustrations in Latin America since the early nineties is the high volatility of international capital flows. The sequence of financial crises

that started with the so-called Tequila crisis in Mexico in 1994-1995 suggests that emerging market economies (EMs) could be seriously vulnerable to shocks stemming from the capital account (of the balance of payments). A sizable and sudden stop of capital inflows (sudden stop, for short) could trigger a series of adjustments resulting in a major disruption of trade and finance. Thus, by raising serious doubts about the sustainability of the initial equilibrium, a sudden stop could plunge the economy into a “bad” equilibrium. Transitions to a bad equilibrium are characterized by large devaluations and major financial disruptions, which translate into significantly lower rates of return, investment and growth.

The sudden stops in capital flows witnessed by the region in multiple occasions during the nineties pose relevant policy questions for Latin American authorities. On the one hand countries could choose to close their capital accounts and limit their investment opportunities to domestic saving availability, or on the other, they could design policies to deal with capital flows volatility. Despite the pain associated with capital flow reversals, empirical evidence suggests that in the long run countries with open capital accounts have deeper financial markets, and hence are able to grow more. Hence it is crucial to develop policies to cope with open but volatile capital markets. Recent studies by the Research Department of the IDB examined how to cope with capital flows volatility by analyzing in detail what makes countries vulnerable to capital flows reversals.

A popular explanation for capital flows reversals is “lack of fiscal discipline”. As the argument goes, crisis-prone EMs have a tendency to run high fiscal deficits, which eventually result in an unsustainable level of public debt. Thus, there comes a time when lenders stop lending, forcing a major domestic adjustment. This explanation is very appealing for the 1980s debt crisis in Latin America, but finds little support in Asia. For example, at the inception of its 1997 crisis, Korea’s public debt hovered around only 10 percent of GDP. Moreover, debt levels in EMs are comparable if not significantly lower than in advanced countries (e.g., Japan). Some argue that what matters are “prospective” fiscal deficits associated with implicit bailout guarantees given to a very fragile (and deteriorating) banking sector.

However, loss of access need not be the result of over-indebtedness, but rather the result of the economy having fallen into bad equilibrium triggered by a sudden stop. This view, amply studied by Guillermo Calvo and his research team at the IDB, finds support in the fact that sudden stop episodes tend to occur around the same time, and for countries exhibiting a variety of fiscal situations. The most outstanding episode was associated with the Russian crisis of August 1998, in which practically all EMs suffered serious sudden stops and an increase in country risk premiums. This should not be taken as saying that public debt is not an important factor but, rather, that by and of itself public debt is not enough to explain the deleterious effects surrounding sudden stop phenomena that have occurred in the last decade, and that external factors also matter.

Hence, policy recommendations to reduce the vulnerability to capital flows volatility need to aim not only at internal but also at external factors. On the external front several proposals have emerged recently, ranging from direct proposals to increase stability by creating emerging market funds to provide liquidity to emerging markets and reduce contagion when specific countries are hit by a crisis, to indirect solutions through the possible impact on stability of prompt debt resolution mechanisms, such as the IMF's SDRM or the adoption of CACs in bonds issuances.

It is by now clear that EMs suffer from structural weaknesses that make them vulnerable—much more vulnerable than advanced economies—to shocks. However, such vulnerabilities can be mitigated with domestic policies. Capital flows volatility has had major impacts in countries that exhibit liability dollarization (i.e., high incidence of foreign-exchange denominated debt), that are highly indebted and that have a closed trade balance. In a highly dollarized economy, a depreciation of the real exchange rate can lead to solvency problems, especially in non-tradable firms. This vulnerability in turn can be translated into the financial sector (since it represents an increase in the credit risk of debtors with such mismatches), and to the fiscal accounts when bailouts occur or are expected. The effect of the shock is magnified when the economy as a whole finds difficulties from switching production to the tradable sector following the real exchange rate depreciation accompanying the shock. Empirical evidence consistently reveals that countries that are closed or dollarized are more likely to suffer from a capital flows reversal than otherwise would be the case. Moreover the vulnerability is exacerbated when both features are present.

Several policy recommendations emerge from this discussion. On the one hand, countries that have not opened their current account should be cautious when opening their capital account. This would raise a significant source of vulnerability. On the other hand, countries need to strengthen their competitiveness position in order to reduce their restrictions for switching to tradable production when necessary. The 2001, IDB report on competitiveness suggests several areas in which Latin America needs to work to promote competitiveness, including increasing the protection of property rights, developing adequate exporting infrastructure, and the like.

A crucial question arises from the research mentioned above: how to deal with currency mismatches. The issue of currency mismatches is less relevant in economies that are more open, at least concerning the private sector. Firms with foreign denominated debt that have higher foreign denominated income will naturally be currency matched. However, the public sector can still remain vulnerable and fiscal weaknesses can materialize when the real exchange rate fluctuates. Fiscal restraint that helps reduce debt stocks is a policy alternative. However it needs to be accompanied by the development of financial instruments to hedge currency mismatches, or of lending instruments contingent to GDP fluctuations or non-tradable prices so that currency fluctuations do not translate into a deterioration of the public sector's balance. These possibilities are currently under research. I hope that in the near future I can update you with some innovative results.

Challenges Ahead and Policies Issues: Financial Sector Development

Indeed, the region has been influenced by international trends and events such as disintermediation, globalization, expansion of the role of institutional investors, and explosion of the demand for risk-pooling instruments. In parallel with these international financial tendencies, many governments in the region engaged in reforms to open up their financial markets, liberalize domestic financial activities, adopt international standards in regulation and supervision and reduce the role of the State as provider of financing. However, financial sector development has been insufficient. Results from reforms in the region are still missing, as we face high cost of capital, credit rationing, small primary securities market, increased foreign share in the domestic financial market with no significant expansion of credit or improvements in credit conditions. Under these circumstances, even though financial reforms presented some positive changes in the microeconomic functioning of the markets of the

region, the problems of stability of the financial system, institutional building, capital formation and of financing economic development remain acute.

Some basic considerations for Financial Sector Development are the following:

- A functional financial system provides the productive sectors and families with a wide range of financing opportunities and access to financing to match their needs so that it becomes a conduit of sustainable development. Even in a stable macro-economic environment, an effective financial system requires institutional building.
- Foreign savings should be part of an overall strategy directed to capital formation and investments, and to avoid disruptions due to the shrinkage of international sources of financing and the destabilizing effects that excessive dependency creates.
- Property rights and their enforcement are limitations to financial development that require legislation and enforcement in conjunction with efforts for the modernization of the state and of the judicial system.
- Local capital market development is highly insufficient to satisfy the demand of companies to amplify and diversify their sources of funding. Ineffective institutions, regulatory inefficiencies, weak corporate governance, hopeless enforcement, and lack of benchmarks are some of the principal factors that do not permit the take off of capital markets.

On the basis of this, let's review those policy issues most relevant in the financial sector:

Financial market development has to be part of the public policy agenda and has to go beyond the time limits of a single administration, but cover a larger time span and become a "project of the State". This is not implying an "interventionist" philosophy, but that policymakers exercise a continuous leadership and guidance of the progress of financial and capital market, provide the legal and regulatory framework, undertake judicial reforms and leave to the private sector to play the game.

The development of domestic financial systems requires patient work on institution building, constant determination to make the rule of law effective to create sustainable financial and capital markets. Leadership has to be politically skillful, but at the same time understand the links among the various parts of the reform agenda, avoiding a piecemeal approach.

Long-term policies should be introduced and implemented to increase the amount of capital formation by the formal financial system by:

- Supporting efforts to develop enabling environments, including macro-economic stability particularly to reduce and ultimately eliminate crowding-out effects of large public deficits;
- Developing appropriate microeconomic setting including regulation and supervision, a legal system that favors the expansion of credit and an institutional structure that introduces effective international financial standards, accounting and disclosure methods as well as a system of governance for the various players;
- Fostering effective judicial systems -as part of the wider agenda for the modernization of the state- that practice enforcement of property rights in the financial and capital markets;

- Improving regulation and supervision;
- Encouraging competitive environments;
- Nurturing local capital markets to facilitate access to financing. To this end, policies should include appropriate corporate governance, accounting rules, creation of benchmarks, provision of incentives for issuing securities, for the creation of liquidity, as well as a permanent effort towards the development of the institutions to provide liquidity to the market;
- Pushing coordination and harmonization at regional level.

This is a very rich agenda. Let me briefly elaborate on some of the policy issues that we consider the most important drivers of financial market modernization: institutional building; regulation and supervision; corporate governance and transparency and enforcement; and benchmarks.

On *institutional building*, there is large evidence that the rules of the game exercise a substantial influence on economic performance as they reduce uncertainty and provide a structure for the day-to-day work. They determine the environment within which individuals and organizations interact. They shape the development of organizations that in turn influence institutions and behavior.

Regulatory and supervisory bodies are typical examples of organizations shaped by the institutional environment. The functioning of these organizations helps the development of the financial market. A lot has been done in the area of regulation and supervision in the region, particularly in the banking sector, but still a lot remains to be done to implant solid and autonomous banking supervisors able to undertake initiatives; establish corporate governance for the functioning of financial institutions; and require disclosure to allow market surveillance and discipline. Supervisory authorities should exercise their function without fear, but have to be held accountable to the executive and legislative branches. In this context of strengthening the regulatory and supervisory sector, there is a complementary need of implementing and enforcing property rights, e.g., creditors rights, to help financial institutions to lend more and reduce their risks.

On the other hand, the consolidations of financial institutions of the last decades are proving that there are people and sectors that are underserved. This would make the case for public sector banks to fill the gap and become vehicles for access to credit of various companies, -small and medium enterprises and micro-enterprises-, and individuals. These special banks have to be placed under the same supervisor of other private banks -without granting them any unduly competitive advantage- and submitted to the same criteria applied to the private sector in terms of solvency, risk, liquidity, governance and enforcement.

The experiences at the end of 2001 and the first half of 2002 show fundamental weaknesses of the systems of *corporate governance, transparency and enforcement*. In the US those weaknesses threatened the function of the market to allocate resources efficiently and put at risk the future of many individuals who had trusted the capital market. The failures of various components of the system have been apparent in many respects: the definition of the accounting rules; the relationship between managers and shareholders; the role of auditors; and the function of the research analysts. Self-regulation proved ineffective, but also the enforcement of supervisory bodies- expected to continuously monitor, oversight and intervene and when needed punish- demonstrated its negligence. Without a correct and

prompt enforcement, we create a too low risk/reward that encourages individuals to defeat the rules in their search of greedy interest. The message for Latin America and the Caribbean is that rules have little sense without acceptance and enforcement and to achieve them we need to work patiently and continuously, going beyond the financial systems to reforms of the state and of the judicial power and ultimately institutional building. The countries of the region are moving in the direction of establishing the rules of the game and in this respect, it comes to mind the efforts that many countries are undertaking to introduce internationally accepted accounting standards and effective governance systems. However, to be credible, these provisions need to be backed by effective implementation and capable institutions.

As the countries move towards building the rules for capital markets, we also need *benchmarks* that set a reliable base for the assessment of risk and return in the market place. Governments have a significant role to play to that end. Both United States and Europe, in different periods of their history, have demonstrated that public debt when contained and framed in a strict fiscal discipline can play a decisive role for benchmark over time of the price of other securities. There has been a lot of work done in this field by the IMF, the World Bank and the IDB and a number of countries of the region, like Mexico, are showing success in creating a stable yield curve of government securities.

The Support of the Bank

One of the objectives of developing a “complete financial system” is to provide companies and individuals access to finance. However, we do not need to fall into the trap of thinking that access to financing is the necessary and sufficient condition for growth. It is not. The fundamental incentive for growth and entrepreneurship is the existence of market opportunities that individuals understand and grab because they evaluate the risk and the rewards. During the recent annual meeting of the Bank, in Milan, in one of the seminars on private sector development, a question was repeatedly asked to the various successful small entrepreneurs of the north of Italy: “*how did you get the financing for your business?*”, “*how were you able to grow and prosper?*”, the answers were always the same: “*financing came from my own pockets, self financing, I could not deal with banks or with the government*”. While these answers may hide an excessive pride, fundamentally, they indicate that market prospects prompt initiative, innovation and growth.

This implies that to be effective the Bank has to be present in various aspects of the economic and social situation of the countries of the region from the productive sector to the social and nonfinancial sector. Among the nonfinancial reforms for sustainable and equitable growth, there are three areas that should be considered priorities: Progressive and more efficient public spending to support efficient and equitable acquisition of human capital, safety nets to enhance risk protection for the poor, and the elimination of social exclusion.

In turn, this entails that the Bank is present in almost all the stages of the public policy spectrum of a country, i.e., problem definition, agenda setting, clarification of alternatives, decisions and evaluation. In this undertaking, the Bank is required to have an overall involvement with various aspects of the life of the country, but at the same time it has to prioritize its actions and concentrate in the most crucial ones.

How are we dealing with these concerns of the countries of the region?

The Bank is part of the public policy agenda in the countries and can help and be effective in agenda setting, in the definition of alternative actions, but it is the government that has to show the commitment and the leadership to select the policy alternative, makes the political decision, and carries the reforms forward. At this juncture, it seems that many countries of Latin American and the Caribbean find themselves in a convergence of conditions that prompt a policy decision: the compelling problem of lack of growth; the existence of policy paths that lead towards expansion; and arguably and more importantly the political will that action is necessary as too many stakeholders are suffering from the lack of development in the region. The Bank can certainly play a major role in this context:

- With its Institutional and sectoral strategies;
- With Dialogue and Technical advice to governments in specific areas;
- With resources, e.g., loans and other operations in support of country programs;
- With support to regional institutions (e.g., regional dialogues; regional banking and regulatory supervisory bodies such as ASBA and Cosra, and ALIDE).

Our focus is on effective implementation and impact beyond the pure transfer of resources (e.g., over the last 5 years, the Bank has approved loans and other operations for a total of which US\$9 billion were directed to the financial sector). Our goal is development effectiveness and impact, and we need a constant monitoring and evaluation of what we do.

Closing Remarks

The tasks ahead are daunting as the productive and financial reforms that we have outlined in this paper have to be intertwined with the socioeconomic agenda. This agenda will mean combining comprehensive programs to improve the coverage and quality of the supply of education and health services; policies and systems designed to improve equity, efficiency, and effectiveness in social spending, and programs to promote demand and investment in these services on the part of the poor.

Under these circumstances, we do have a great responsibility to all our stakeholders to be able to prioritize effectively and to have a substantial and lasting positive impact on improving the standards of living in the countries of the region.

Les agradezco su atención y les deseo el mayor de los éxitos en esta reunión.

Muchas gracias.