(2000)

Notes for comments to MIT Latin America conference, Friday March 3

The Economy

Latin America is in better shape than anyone dared hope a year ago. GDP began to recover in 1999Q3, after three quarters of declines. Recovery is expected to broaden and strengthen this year, driven by higher domestic demand and exports. Rising commodity prices are also supporting domestic demand and easing external financing constraints. Growth is set to accelerate to 4 per cent through this year, with inflation under control.

The crises were far from painless. But the economic impact was less severe than the 1980s debt crisis and the more recent crises in Asia might have suggested:

- **Output** was virtually flat in 1999 and is growing strongly now, having fallen 0.8 per cent in 1982-83. (But this masks big country variations in performance.)
- **Financial collapse and hyperinflation were avoided.** Currency crises were resolved relatively quickly (except Ecuador). There were few systemic banking crises (except Ecuador and Paraguay). Inflation has continued falling.
- **Access to international capital markets was maintained.** Net capital inflows almost halved between 1997 and 1999, but bond issuance picked up at the end of last year and spreads are now barely 100bp above their pre-Russian crisis levels. In the 1980s, net capital flows were negative for much of the decade.

Outlook varies significantly from country to country. Impressive performers include:

- **Brazil,** which defied expectations of a fall in output in 1999 as a whole. 4 per cent growth is now likely this year. Inflation has fallen despite the depreciation. The current account deficit is set to shrink, while fiscal problems at the root of the crisis are being tackled. Together with successful implementation of inflation targeting, this should support recovery through lower interest rates.
- **Mexico** maintained reasonable output growth through the regional slowdown, helped by US demand for its exports. The current account deficit fell below 3 per cent of GDP last year. There is scope to make further progress in medium-term fiscal policies. The regulation of banks also needs further strengtheing. Growth of 4.5 per cent is likely this year, following 3.5 per cent in 1999.
- **Argentina** saw output fall 3 per cent in 1999, but the Brazilian pick-up should boost exports while reduced domestic political tensions should contribute to lower interest rates.GDP should rise 3.5 per cent this year, with inflation remaining low. Further fiscal consolidation and labor market reforms are needed.
- **Chile** and **Peru** are set to grow by 5.5 and 4 per cent a year respectively this year, helped by depreciation, lower interest rates and stronger commodity prices. They need to maintain their strong fiscal positions and low inflation.

Colombia, Venezuela and Ecuador have had a more difficult time, recording output falls of at least 5 per cent last year. They need sounder policies to secure sustainable recoveries:

- There are tentative signs of recovery in **Colombia,** with 3 per cent growth expected in 2000. But sustaining recovery will require measures to strengthen the banking system, tighten fiscal policy and accelerate privatisation.
- **Venezuela** was hit by floods and mudslides in December. Higher oil prices have boosted export earnings and helped finance reconstruction. 3 per cent growth is expected this year, but the sustainability of recovery is in question with inflation likely to remain at a relatively high rate of around 20 per cent.
- Little or no growth is expected in **Ecuador** this year. Depreciation and rapid monetary growth has fuelled inflation. The country faces severe difficulties in the financial sector and with foreign debt servicing. If dollarization is to encourage stability, it must be accompanied by fiscal and structural reform.

Over the region as a whole, several factors helped mitigate the impact of the crises:
- **Speed and determination with which countries adjusted policies:** Countries were prepared to take unpopular monetary and fiscal measures. They also rejected a return to interventionism and siren calls to close off their economies.
- **Institutional and structural reforms during the 1980s:** Central bank reform allowed faster and more consistent policy responses. Better bank regulation meant financial systems were in better shape to weather devaluations and monetary tightening. Resolute stabilization efforts had eroded inflationary psychology. Market deregulation had encouraged long-term foreign direct investment.
- **The international community reacted swiftly:** The IMF provided help and industrial country central banks aggressively eased monetary policy.

But the region remains vulnerable. The four largest Latin American countries are likely to have a **combined current account deficit of $50bn this year**. Gross external refinancing requirement may be around $160bn, high relative to export earnings. A fall in private capital flows – from unexpectedly sharp US interest rate increases – could require an uncomfortable depreciation or domestic slowdown to bring about the necessary current account adjustment. A sharp slowdown in the US economy would have mixed effects, hurting countries with strong trade links (Mexico), helping others via a weaker dollar (Argentina, Brazil, Chile).

Hence policymakers should:
- **Tighten fiscal policy, given the resurgence in deficits which was taking place by the end of the 1990s**, not least because it is a source of potentially destabilising market anxiety. Measures could include: crackdowns on tax evasion and exemptions; imposition of hard budget constraints on regional governments and public sector bodies; better public sector debt management.
- **Promote good governance.** Measures could include: meeting transparency and data standards, strengthening financial and non-financial regulation, and strengthening corporate governance (accounting and disclosure standards).

Inequality

Latin America has greater income inequality than any other region in the world. The richest 5 per cent of the population receive a quarter of national income and the richest 10 per cent take 40 per cent. By way of comparison, the richest decile in the US receive less than 29 per cent of national income, according to the latest data. Only a few, much poorer, African economies exhibit similar inequality, according to an analysis of Deininger and Squire's World Bank dataset in the IDB's 1998 study: *Facing Up To Inequality in Latin America, IDB, 1998*). Needless to say, data problems dog many statistical estimates of inequality.

The **big disparity lies between the richest 10 per cent and everyone else**. Gaps between the middle-income groups are not particularly pronounced. Indeed, if you look at Gini coefficients with the richest decile excluded, income inequality does not differ systematically between Latin American countries and the US. Neither does inequality reflect a few very rich families. Poverty is widespread with 150m – one-in-three – on less than $2 a day.

What makes the richest 10 per cent of the Latin American population so different?

- **Education:** Heads of household in richest decile average 11.3 years of education, 2.7 more than the next decile and 7 more than the poorest 30 per cent. Returns to education appeare to have risen in most of Latin America during the 1990s.
- **The work they do:** A quarter of heads of household in the richest decile work directly as professionals, technical personnel or senior executives. Over than 1990s, the earnings gap between professional/technical workers and the less skilled rose by more than 4 per a year on average in 10 out of 14 countries.
- **Where they live:** Poor households are mostly in the countryside, the rich in cities.
- **Children:** The richest decile have fewer children, speading income less thinly.

Income distribution improved with rapid growth in the 1970s. But improvements were wiped out during the "lost decade" after the debt crisis, with the richest decile gaining income share at everyone else's expense. (In addition to the direct economic effect, spending on social programs and safety nets fell sharply.) During the 1990s, high inflation has been tamed, deep structural reforms implemented and growth restored. In the first half of the 1990s, middle-income groups gained relative to the richest and poorest, leaving **aggregate inequality stagnant at high levels**. According to Londono and Szekely's *Persistent Poverty and Excess Inequality: Latin America 1970-95* (IDB 1997), the richest decile and the poorest two deciles lost income share between 1990-95 while the remaining groups in the middle gained.

The distribution of income is often relatively unequal in the early stages of development, but improves subsequently. The IDB estimates that Latin America's **stage of development** (proxied by per capita income and demographic indicators) explains a third of the gap between aggregate inequality measures in Latin America and industrial countries. There are good reasons to expect this part of the gap to narrow in the future:

- **Capital accumulation:** In early stages of development capital is scarce and the returns on it very high. Profit shares in Latin America are still very high, but will decline as development continues and capital stock expands.
- **Urbanization:** City incomes are higher and grow more quickly, so urbanization raises then reduces inequality. Most Latin Americans are now city dwellers.
- **Formalization:** Incomes in the formal sector tend to outstrip those in the informal sector. So formalization increases inequality to begin with, but then improves it because incomes are less widely dispersed in the formal than the informal sector.
- **Education:** When countries establish or expand education systems, inequality rises as younger cohorts accumulate greater earning power than older ones. Once the majority of the population is educated, inequality starts falling as the rest are.
- **Demography:** Fertility rates are now declining, allowing more women to work and families to concentrate more resources on fewer children.

Geography is more important, explaining half the inequality gap, according to the IDB. Ceteris paribus, countries near the equator tend to have higher inequality than those further away. **Tropical conditions hamper labor productivity**, so industrialization takes place in a buyers' market for labor. Big economies of scale for most tropical crops (eg cotton, sugar, tobacco) promote **extreme concentration of land ownership** and give employers market power over labor. Interestingly, rice is not subject to large economies of scale, which may hence explain why there is less concentration of land ownership and inequality in East Asia.

Inequality is also relatively high in Latin America because of **macroeconomic volatility**, in part arising from reliance on commodity exports. This contributes to inequality because the poor are less able to weather shocks and may be forced into actions that limit their and their children's long-term earning power. Recessions keep the young in **education** in rich countries and push them out in poor ones. After the Mexican crisis in 1995, 5 per cent of 12-25 year olds were forced into the labor market. Downturns can also erode long-term human capital through their impact on **health**. In three quarters of Latin American crises over the last 20 years, inequality was higher after the onset of the crisis than before, according to Nora Lustig (*Crisis and the Poor: Socially Responsible Macroeconomics*, Presidential Address to Latin American and Caribbean Economic Association, 1999). Crises have tended to ratchet up inequality, as the subsequent recoveries have not repaired the damage.

Development, geography, structural factors and macroeconomic performance all have their part to play in explaining the pattern of ineqality. But it is important to remember that these factors interact in complex ways and the links are not inevitable.

Why do we care? In addition to social justice, the IDB concludes from albeit mixed empirical evidence that: "**Good income distribution tends to stimulate economic growth**". Perhaps in part because stability and an absence of distributive conflict boosts private investment?

Mr Aninat writes that development "wobbles like a table missing a leg or a building whose foundations are not strong enough if it does not lead toward greater social equity and the

income distribution that society considers more acceptable and reasonable". (*Distributive Justice and Economic Development: The Case of Chile and Developing Countries*, ed Solimano, Aninat and Birdsall, Michigan University Press, 2000). Inequality may also harm growth because it encourages populism and big fiscal deficits arising form efforts to please the median voter. Liquidity constraints on the poor also limit saving and investment.

Policy recommendations might include: Better social safety nets to insulate the poor in crises, avoidance of unnecessarily abrupt macroeconomic adjustment, removal of labor regulations favoring insiders, targeted educational and healthcare support for the poor, improved public services to allow more women to work, measures to make credit more widely available, fully-funded pension systems to increase the available pool of savings.