ECONOMIC REFORM IN LATIN AMERICA AND THE CARIBBEAN AND POSSIBLE IMPLICATIONS FOR CUBA

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Thank you for the opportunity to join you in Miami today and participate in your stimulating discussions on the Cuban economy. The main focus of my remarks will be a broad overview of the recent reform effort in Latin America and the Caribbean.

Some may say that the differences between Cuba and the rest of the region are so large that this experience is of little relevance for Cuba. But I submit that in spite of some very obvious differences, there is significant common ground, and that Cuba can draw important lessons from the experience of other countries of the region. More specifically, I believe that in the early 1980s Latin America and the Caribbean faced a sudden reversal in its external circumstances that is in many ways similar to that faced by Cuba in the 1990s: economies that were relatively closed and heavily regulated had to cope with an abrupt deterioration in their terms of trade and a sudden drying up of external finance. This led to a period of protracted financial instability and weak economic growth that many have labeled as "the lost decade" for Latin America and the Caribbean.

There is, however, a more positive angle to these developments. I believe that the debt crisis provided the region with a "wake up call" that highlighted the shortcomings of the region's traditional approach to economic policy: its reliance on heavy state intervention to reach objectives that proved to be ever elusive. This new awareness prompted most countries in the region to implement deep, extensive reforms that have increased the region's potential output and raised income growth in the region and—what may even be more meaningful—have put it in a position to better withstand new kinds of adverse external shocks such as the Mexican crisis of 1994-95 and the current financial crisis in East Asia.

THE DEBT CRISIS OF THE EARLY 1980s

But let me first recall briefly the Latin American debt crisis of the early 1980s. As I mentioned earlier, it resulted from both domestic and external factors. You will remember the external context: after an era of rapidly rising oil and other commodity prices and seemingly unlimited financing at relatively low interest rates in the 1970s, Latin America's key export prices declined markedly in 1981-82 while international interest rates rose sharply, both contributing to a marked widening in the region's current account deficit (from 2-3 percent of GDP in the late 1970s to 5½ percent in 1982). At the same time, there was a drying up of financing (the well known recycling of dollars by oil exporters came to an end), and eventually a sharp contraction in foreign capital flows to the region (from a record US$52 billion in 1981 to less than US$8 billion a year over 1983-89).

But these external developments also unmasked profound imbalances in the region's economies themselves. These imbalances were reflected on a sharp increase in *foreign borrowing*, the mirror image of the lending I just discussed, with the region's foreign debt quadrupling in barely seven years (from US$74 billion, or 19 percent of GDP, in 1975, to close to US$300 billion, or 43 percent of GDP, in 1982). These imbalances also reflected was the pursuit of *inconsistent and unsustainable macroeconomic policies*, including in particular the combination of fixed or heavily managed exchange rate regimes with overly lax fiscal policies (the region's fiscal deficit grew from an average of 2 percent of GDP in 1975-79 to 4.5 percent in 1982); as a result, many currencies became seriously overvalued in the early 1980s—for instance, between 1979 and 1981 the Chilean peso appreciated by 37 percent in real effective terms, the Mexican peso by 27 percent, and the Argentine peso by 19 percent. And in the structural area, most of the economies of the region had for decades followed *a misguided development model based on import-substitution, pervasive state intervention and ownership, extensive price and other quantitative controls, and extremely high tariff protection*. As a result, exports accounted for barely 10 percent of GDP in the early 1980s, compared to about 15 percent for OECD countries and 30 percent for Asia. Relative prices were highly rigid and productivity growth was low. Such heavily regulated, distorted and overheated economies were clearly in no position to respond to a rapidly changing external environment without major economic disruptions.

The economic impact of the 1980s debt crisis was particularly severe: output growth and investment dropped following the onset of the crisis, in some countries by very large amounts, and were generally slow to recover. Inflation surged to unprecedented levels, and exchange rates fluctuated wildly, generating considerable strains on domestic financial institutions, which in many countries had to be intervened and restructured. Such financial instability undermined investors' confidence and often contributed to a vicious circle of ever lower investment and growth. In all, by the end of the "lost decade," average output per capita in Latin America and the Caribbean was still below that registered ten years earlier.

THE REFORMS OF THE LATE 1980s

What was the policy response to the crisis? There was of course *no common policy reaction* across all countries. Some countries embarked on an ambitious reform path early on, while others tried to deny the profound nature of the external changes that had occurred and treated them as temporary; still others reacted by initially stepping up direct intervention in markets. The scope of reform, and its sequencing from one policy area to another, also differed markedly across countries.

Eventually, however, a common strategy did emerge—one that represented *a radical turnaround in the region's approach to economic policy, from one based on heavy government intervention to one that relies on market forces*. Sooner or later in the aftermath of the debt crisis, most governments in the region opted for leaving behind the old views that sought to maintain the public sector as the engine of inward-looking economic growth, and embraced an outward-looking, market-based economic agenda, rooted in the conviction that freer markets make it possible to use productive resources more efficiently and lead to faster, more equitable output and income growth. A key objective of economic policy has thus come to be a widening in the scope of markets and improvements in how they function, instead of curbing their development and distorting their operation. This is a remarkable departure from decades of state intervention, with far-reaching consequences in all areas of economic policy.

If we look more closely at specific reform policies, we can identify four basic areas of action: fiscal reform; improved monetary discipline and a radical change in the way monetary policy is conducted and financial savings allocated in the economy; trade liberalization; and privatization.

- Let me start with *fiscal policy*, possibly one of the most important areas of reform. For the region as a whole, the overall fiscal balance improved from a deficit of 4-5 percent in the late 1980s to about 2 percent in the past few years. Of the 32 developing countries of the region, about 20 countries have improved their fiscal balance between 1989 and 1997, often by a sizable amount. In many cases, this has required an overhaul of the tax system, significant reductions in government expenditure, extensive institutional reform, including through the complete or partial overhaul of social security systems, and the restructuring or privatization of public enterprises and public financial institutions to eliminate their operating losses. Such measures are not easy to take, particularly in a context of weak economic growth and large social demands for government programs. But I cannot overemphasize the critical contribution that this fiscal consolidation has made for the stabilization of the economies of the region. And it is also important to remember that a sounder fiscal sector helps improve the efficiency of the economy, as it allows scarce financial resources to be dedicated to productive, income-generating investment.

- A second key element was *improved monetary discipline and changes in the conduct of monetary policy*. The shift in monetary policy was of course facilitated to a large extent by the improvements in the public finances. At the same time, direct credit controls were abandoned in most countries, bank reserve requirements were lowered substantially, and interest rates were deregulated and allowed to reach positive levels in real terms. As a result, money growth slowed sharply in most countries, and inflation went down from an average of 900 percent at the end of 1990 to less than 11 percent at end 1997, the lowest level in 30 years. So that in this region once known for stratospheric rates of inflation, in many cases close to hyperinflation, by the end of 1997 only two countries had inflation rates over 30 percent. At the same time, significant institutional changes were introduced to the region's financial sectors, including the modernization of banking regulations and the establishment of more demanding prudential standards.

- In the area of *trade*, tariffs were reduced and unified, falling from a regional average of over 40 percent in the mid 1980s to less than 14 percent at present; the once pervasive import permits and other quantitative restrictions on trade were for the most part eliminated, with their coverage falling from 36 to less than 6 percent of imports. And finally, the multiple exchange rate regimes that had become common in the aftermath of the debt crisis were also dismantled, and they are now the exception—in fact, most of the Latin American and Caribbean region now subscribes to the Article VIII of the IMF's Charter, which means that they maintain no restrictions on their current external transactions. Restrictions on capital transactions were also eliminated or at least significantly softened.

  With this change in external policies, external trade of the developing countries of the region has increased markedly. It is particularly interesting to note that exports have grown to about 12 percent of the region's GDP. And with the reduction of controls on capital *outflows*, capital *inflows* to the region have increased over tenfold, from some US$8 billion a year in the early 1980s to about US$40 billion in the early 1990s and US$90 billion in 1997. Importantly, reflecting regained invertors' confidence, private, long-term investment flows now account for the lion's share of this total.

- Finally, the scope of *privatization*—another highly visible component of reform—has been remarkable. Over 800 enterprises have been privatized since 1988, many of them in the utilities sector, which traditionally was closed to private sector participation and where the potential for productivity and efficiency gains is ample. There have also been significant sales in the financial and banking sectors, thereby bolstering financial sector reform. More generally, many markets have been deregulated, and many restrictions to the development of private enterprise eliminated.

As I said earlier, the specific scope and pace of each of these reforms has varied significantly among countries. But the drive to implement them has been bold and comprehensive in the whole region. In fact, many analysts have now come to emphasize that in the area of structural reforms, most Latin American and Caribbean countries have advanced farther in a decade than many European or Asian countries have in over 30 or even 50 years.

THE IMPACT OF THE CRISIS IN ASIA AND THE POLICY RESPONSE

I would like to discuss how this shift in policies has strengthened the economies of the region and enabled them to recover quickly from the Mexican crisis of 1994-95. But time is short and I will jump to the current situation where the preliminary conclusion that one can draw point in a similar direction. The story of the crisis in Asia is far from fully told at this point, but it clearly has been affecting Latin America and the Caribbean through the same two major channels as the debt crisis: a sharp contraction in foreign financing coupled with a significant terms-of-trade loss.

- *Medium- and long-term capital inflows* to the region, which had been averaging US$8 billion a month through the first ten months of 1997, fell to an average of US$3.5 billion a month from November 1997 through February 1998. There was also a notable decline in stock prices: a regional composite index of stock prices fell by 30 percent from its level in September 1997 (in U.S. dollar terms), in some cases reflecting a fall in domestic asset prices compounded by currency depreciation. I want to point out that neither of these factors—lower asset prices and currency devaluation—has led to a major banking collapse, as it had in many cases the early 1980s. Moreover, capital inflows were quick to rebound when there was at least a temporary respite in the crisis situation—inflows went back to US$7 billion a month in March-May 1998—although there are indications that they subsequently weakened again.

- At the same time, *external markets turned very sluggish under the impact of a decline in import demand from Asia and a sharp drop in the world prices of oil and other key commodities*. The average price of the main commodity exports from Latin America and the Caribbean fell by over 30 percent between October 1997 and June 1998. Nonetheless, and partly reflecting the impact of trade liberalization on export diversification, other exports, mainly manufactured goods, were broadly unaffected.

In stark contrast to the experience of the early 1980s, the policy response of countries in our region to the Asian crisis was fast and unequivocal. In most cases, the authorities have expressed swiftly and clearly their commitment to macroeconomic stability. They have tightened credit policy and taken additional and often painful fiscal adjustment measures to stabilize their currencies and restore market confidence. So far, they have been relatively successful in their attempts, partly because of the swiftness of their policy response, and partly because of the stronger and more resilient economies they now manage, themselves the fruit of previous reform efforts. Banking reform, for instance, has enabled the authorities to significantly tighten credit policy without compromising banking soundness. Output growth is expected to slow, but remain at a respectable 3 percent (from 5 percent in 1997). Encompassing privatization and market deregulation have attracted large foreign direct investment (FDI) flows, thus reducing the region's vulnerability to more volatile short-term inflows. And close to one year after the onset of the crisis, most Latin American and Caribbean countries have maintained their external credit ratings and their access to voluntary private financing, as evidenced by several recent successful bond issues—albeit at higher spreads.

Important risks and challenges remain, however, and it would certainly not be prudent to claim that the region is on safe ground. There is the risk of policy slippages, particularly in the monetary and fiscal areas. Many governments of the region are facing or preparing to face electoral contests, and there is the temptation to ignore external developments or to resort to populist financial policies or misguided policy responses such as the reintroduction of trade barriers. In my recent visits to countries of the region, however, I have been encouraged by the authorities' awareness of these risks, and by the efforts they are making to gain political support for measures that can help defend their economies from further negative shocks and sustain their ability to grow.

What should be the focus of these measures? First, furthering reforms in areas where they have often stopped short, such as fiscal reform, improvements in the targeting of social programs, particularly in the areas of education and health, and the strengthening of banking practices and banking supervision. And second, broadening the reform effort to address new, in many cases unchartered areas such as labor market reform, competition policies and governance, whose importance for effective economic performance on today's global markets have been clearly evidenced by the Asian crisis.

CONCLUDING REMARKS: POTENTIAL LESSONS FOR CUBA

In the end, what are the lessons from the Latin American and Caribbean experience that are relevant for Cuba? I am no expert on the Cuban economy so I will leave to others the task of drawing concrete conclusions on this subject. However, I think that two general policy lessons can be drawn that can be of use for Cuba as for other economies transiting to market-based principles. The first is that stabilization must be an immediate, unrelenting objective; the second is that the strategy of structural reform must be boldly comprehensive, and encompass at the same time price and market liberalization, public sector reform, and the development of a modern legal and financial infrastructure.

First, **steadfast stabilization is the key to any successful economic reform strategy.** The initial stages of liberalization are likely to be associated with a surge in prices, especially when price and other quantitative controls were pervasive. The removal of price controls and of direct or hidden subsidies, as well as trade liberalization, will lead to an increase in the price of many goods, particularly tradables, from their previously low, subsidized level; it will also release a previously pent-up demand for foreign goods. In this context, traditional stabilization policies, through monetary and credit restraint and fiscal austerity, must be at the top of the economic agenda.

The Latin American and Caribbean experience shows, however, that inflation may only respond with a lag to financial restraint, because of a number of factors such as unexpected fluctuations in the velocity of or demand for money, inflationary expectations and uncertainty with respect to the future macroeconomic stance, and the ability of other agents—i.e., local governments or public enterprises—to offset monetary restraint through informal credit or payment arrears. In those cases, the authorities' determination to resist demand pressures and keep tight financial policies until inflation effectively subsides has been a major element in ensuring the eventual success of reform. Supporting policy measures that clearly signal the authorities' commitment to reform and stabilization also have been used to facilitate the disinflation process by enhancing credibility and confidence in the currency. These include wage restraint, the maintenance of positive rates of return on domestic monetary assets, and steadfast advances in the structural area, including through privatization. Some Latin American countries, most notably Argentina, also have used a fixed exchange rate to help stabilize their economies; however, policy makers should remember that the use of an exchange rate peg does require a strong commitment to supporting adjustment measures, particularly fiscal restraint, while the experience of several other countries has shown that a peg is not necessary for the achievement of stabilization objectives.

The crucial importance of stabilizing quickly, and of maintaining sound financial policies thereafter, has gained new relevance in today's global goods and capital markets, because there is even less room for policy inconsistencies or complacency. In the global environment, market anxieties can spread quickly from one country to another, rapidly exposing underlying weaknesses. Misguided policies can then have more abrupt and pronounced consequences than in the past; and sound, prudent macroeconomic policies are even more important, because markets are not forgiving—much less forgiving, I must say, than official financial institutions like the IMF. Polcy makers must stand ready to react quickly to signs of emerging imbalances, before market pressures build up. As I said earlier, in the aftermath of the Asian crisis the prompt policy response of the authorities in the Latin American and Caribbean region was key to maintaining financial stability. Such a capacity for swift response is becoming an even more central element of sound macroeconomic management, and policy makers should ensure that they are able to address underlying weaknesses rapidly and decisively.

Second, **the accompanying effort at structural reform must be comprehensive.** The agenda is very wide, but three elements appear as effective cornerstones:

- the *steadfast liberalization of prices and the deregulation of goods and labor markets*; this includes the liberalization of all foreign transactions, including trade, foreign exchange operations, and foreign investment. These are key elements to prompt the required shifts in labor and other resources and elicit a quick supply response, thus minimizing the length and costs of the adjustment period, and which has had a clear positive impact in the region;

- there is a need for *a deep reform of the public sector, both at the level of the government and at the level of public enterprises*. Overall, its size must be reduced, and its efficiency increased. For the government, an encompassing tax reform must be designed together with efforts to control and redirect spending to its most efficient use, including through a means-tested social safety net. Public enterprises should be privatized quickly, and if delays are encountered in this process, they should be immediately reformed to respond to market signals, with subsidies or credits eliminated or severely curtailed; and

- the authorities should develop a *modern legal and financial infrastructure*, including a sound banking and payments system, properly regulated, as well as a set of laws and institutions suited to a market economy, such as enforceable property rights and bankruptcy laws. Simultaneous, complementary advances in each of these three fronts are required to foster the development and smooth, efficient functioning of markets.

The importance of many of these issues has been clearly underscored by the recent crisis in East Asia, as now they have come to the forefront of any reform agenda, including in industrial countries. What we see is an environment where countries, without consideration for ideology, need to make a hard but inevitable decision to integrate with the world economy. Such choice would help create the conditions for sustained economic growth with stability, that would be required to survive as viable economic, social and political entities.