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Quo Vadis Latin America? (Part Dois)

by José M. Barrionuevo*

Latin American political trends have changed markedly over the last three years. Many countries are now looking for radical change to address long-standing poverty, rising unemployment, and what is perceived to be the failed promises of prosperity that liberal economics was thought to bring. The new choices that Latin Americans are making appear more like a cry of frustration, rather than an ultimate answer. Most of the governments now being replaced portrayed a new era of sound macroeconomic policies and open markets that was to help Latin America grow out of poverty during the 1990s. Not surprisingly, the failure of these governments has been tied to the failure of markets and neoclassical policies that were bound to bring an oasis of prosperity. Ironically, as soon as the new “radicals” take office, they realize that the room to bring the promised change in the election is over with the election itself. In most countries, their ability to persuade congresses or to flesh out change for the better is much lower than most thought it would be. This has paved the way for the incredible degree of incompetence that rambles through Latin America these days and has actually worsened economic conditions. In extreme cases, such as Venezuela or Argentina, the collapse of the private economy is the result of the ignorant belief that the country can grow without its private businesses or the belief that breaking property rights and most contracts would magically put the country in a new growth era.

The idea that change is needed because sharp market policies and reforms have failed Latin America is flawed. In fact, Latin America’s real problem is that little has changed and that the failure to break with the past is the reason crises continue to deepen. In fact, the so-called pro-reform governments consistently break the deeply entrenched interest groups that for decades have been so successful to prevent change in the structures of Latin economies. Without structural changes, Latin American growth is bound to remain weak, barring the usual cyclical U.S. pullout that results in brief periods of growth. Interest groups run from the old-fashioned businesses, that are not willing or

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able to compete, to the politicians, that represent the interest of businesses or “prominent families” in Congress that also have family members running many things, from state offices to hospitals, etc. In this sense, as it’s fairly well known, corruption remains a crucial problem. The fact that these interest groups can prevent a nation from achieving the solutions that many times are obvious to most people suggests, of course, that Latin American nascent democracies still fail to represent the interests of the population as a whole. This does not mean that elections do not represent the will of the population, which they do, but rather that politicians once in office are either captive to a system that fails to bring change or they become embedded in the agenda of interests groups. A Brazilian Congressman put it well a few months ago when he said “Power is like a violin, you take it with your left hand, but play it with your right.”

The initial excitement surrounding the perceived pro-market policies and the success of Latin America in the first half of the 1990s had to do mainly with the ability of every country to conquer inflation and, more importantly, with the idea that inflation needed to stay low to have a chance of strengthening investment and growth. Remarkably, this idea was new at the time. Even in the early 1980s in Mexico, late 1980s in Argentina, and early 1990s in Brazil, rampant inflation was the norm of the day, with some governments even stating, as former President José Lopez Portillo of Mexico did, “[w]e will grow with inflation.” Of course, growth and inflation are not compatible. To this day, this has been the remarkable turnaround of Latin America. Beyond inflation, some of the so-called first generation structural reforms were pursued, but the most critical reforms were never sought because governments were never able to break the deeply entrenched interest groups, which of course made every effort to preserve their practices.

After decades of high inflation and growing income disparities and poverty, the “lost” decade of the 1980s led many to realize that with inflation and without foreign investment, growth would never pick up. There was also a clear realization that the state could never replace the private actions of firms and individuals in building an engine of growth. Conquering inflation thus became a sharp, political platform that was incredibly appealing and popular for a simple reason: lowering inflation benefits everyone and no one has to pay for it. There are, therefore, no choices to be made and everyone becomes happier. This was the most important success of the 1990s that extends to this day. It is, therefore, not surprising that today inflation is the greatest threat to the future of politicians in Latin America. This goes for every nation from Argentina and Venezuela to Colombia and Brazil. Not surprisingly, low inflation is the greatest legacy of the 1990s that the new democracies in Latin America are trying to preserve everywhere. The challenge is also, of course, to keep inflation low. As Argentina and Venezuela are beginning to witness, keeping inflation low will come down to whether sharper structural reforms are pursued.

So what went wrong? The perception that Latin America was successful in adjusting is flawed, despite some progress. All Latin American countries were successful in pursuing sharp stabilization policies, which controlled fiscal and monetary policies, bringing down inflation. The success of
macro policies was largely due to the fact that the new efforts coincided with the liberalization of capital flows and financial globalization. This benefited everyone since globalization allowed for capital inflows that boosted growth, making the idea of modernizing politically appealing. Modernization worked because it brought growth. In fact, the closed economy feature of Latin America during the 1970s and 1980s explained the past boom and bust cycles, as governments sought to bring inflation down. But with no credit inflows, weak growth improvements followed by unemployment pressures derailed adjustment efforts usually a year or two later. The bottom line is that capital inflows and indeed globalization made it easier to pursue tighter macroeconomic policies and some reforms as it pushed countries into virtuous cycles. That gave reformists and neoclassical economists a new crowd in Latin America because the whole notion of accelerating growth prospects by attracting enormous private capital inflows, compared to multilateral handouts, became appealing for politicians. Financial liberalization and the new success stories meant sharp capital inflows. The financial inflows themselves were not the problem. The issue was the market imperfections and lack of reforms to ensure that financial inflows would find their way to the productive investments, which are pursued by foreign direct investment. In a world with no imperfections, of course, whether you invest $1 in the stock of a firm or you put it to work directly would be irrelevant if you had the same know-how and marginal efficiency of that firm. Further, governments found a new source of financing that defer adjustments into the future because financing resulted in the standard time-inconsistency problem. Because inflows financed current consumption rather than investments, financial pressures were bound to re-emerge in many countries.

Many Latin American countries were also successful in pursuing some so-called first-generation reforms. Notable among them were basic fiscal reforms that gave the second important boost to private businesses as trade barriers were dismantled, public businesses (once private) were re-privatized, capital flows were freed, and essential fiscal reforms were pursued to “ease” the burden of the state on businesses and citizens. However, very few Latin American countries went on to pursue successful social security reforms, including pension and health reforms, and even fewer have pursued labor and other political and legal reforms. Chile is to this day the only country that early on sought to change the structure of its economy in a meaningful way.

The failure to pursue structural reforms was straightforward. When inflation goes down, everyone benefits but when structural reforms are pursued, you need to choose who pays for what and who is not going to get whatever they were getting before. Everyone is for reform as long as someone else pays for it. This is where leadership becomes an extraordinary asset. Fear and ignorance play a role here since, in their quest to not adjust, interest groups appeal to ill-conceived nationalistic ideas that range from selling out the country to threats of massive unemployment. Ironically, interest groups favor privatizations that they don’t control because poorly conceived privatization processes offer an opportunity for profit or for controlling new interests. Not surprisingly,
privatizations were pursued with many irregularities in most countries. This means that, far from improving efficiency, control just changes hands in what remains inefficient and, in most instances, uncompetitive environments. Trade is also favored because consumers have limited choices and the perceived loss in competitiveness due to foreign competition is offset by the access to new and better products and inputs that help local firms compete.

More importantly, essentially no Latin American country has pursued a political reform that balances power effectively between the three branches of government and brings an improved judicial and legal framework. Typically, the Executive branch is a hostage of Congress when it chooses to pursue major structural reforms or of the Supreme Court (as Argentina has seen for years) that derail without notice the actions of the Executive or Congress or both. This is also the reason why a fiscal responsibility law typically does not reassure anyone that things can change. Having an independent and competent legal system remains one of the most underestimated changes or reforms that Latin America badly needs. In brief, the lack of institutional features, combined with an “individual dependent” regime, whether for better or worse, results in the stop and go choices that characterize investment. Further, it perpetuates the “good regimes” booms and the “bad regimes” busts that characterize Latin America. Not surprisingly, in such a dynamic there is no such thing as the long or even medium run. The stop and go feature of Latin America introduces a sizable risk premium that only allows for highly profitable, short-run (speculative) investment opportunities. Nowhere is this clearer than in Argentina as a two-day President and a flawed legal system showed when the country defaulted on its market, bonded debt. On the other hand, in most countries, the “legal” and “judicial” regimes are so outdated that citizens pursue “common sense” practices outside the formal law. Mexico is a good example of this. Marred in outdated laws, Mexico’s legislation restricts many investments and allows for outdated labor laws. Labor practices, however, are much more flexible because of the unpopularity of usually corrupt labor unions and thus the implied easiness to strike agreements with the surviving unions. “Not being legal,” however, is still a major drag because it makes the firms and the workers vulnerable to changes in the regime or leader. Further, it limits the legal recourse that firms have and, in doing so, prevents the development of property rights that would encourage investment. At best, legal loopholes drag the process for too long, further increasing transaction costs.

The perceived view that Argentina was an innocent bystander of a cruel world, as it actually adjusted through most of the 1990s, especially in 2001 heading into the crisis, is flawed. Looking at Brazil, as well, one can conclude that many key reforms are still needed. In the end, all of these Latin American countries as examples will lead us to conclude that it is not realistic to pursue “long-lasting” economic reforms of any kind if sharp political and legal forms do not precede them.