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# Sustaining Global Growth and the Way Forward for Latin America

Remarks by Horst Köhler
Managing Director of the International Monetary Fund
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Governor Caruana, ladies and gentlemen, distinguished guests:

1. It is with great pleasure that I take the opportunity to address you this evening, during my first visit to Spain as Managing Director of the IMF.

2. **The world is facing great uncertainty at present.** Spain, as a member of the European Union with historically strong ties overseas, is especially aware of this uncertainty. Consumers and investors remain cautious and the recovery in the world economy is weaker than earlier anticipated. But barring a protracted war in the Middle East, which is unlikely, I expect the tentative recovery to continue: the economic policies of the larger advanced economies remain broadly supportive, and there is some further scope for monetary easing should that prove necessary. For 2003, I expect global economic growth to slightly exceed last year's level of 3 percent.

3. **Although we know that full confidence is unlikely to return until the geopolitical tensions have subsided, we must avoid undue pessimism.** Despite the series of large shocks in recent years, the global economy and the international financial system have proven remarkably resilient. And more fundamentally, we are in the midst of a technological revolution, in particular, in information technology, in nano technology, bio-technology and in medical sciences, which has the potential to sustain global growth for many years to come. I expect markets to bounce back.

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4. **Among the regions of the world, Latin America is facing particularly difficult economic circumstances.** In 2002, real GDP fell by about ½ percent for the region as a whole, led by a sharp recession in Argentina. The adverse global economic environment brutally exposed weaknesses in the domestic policy framework in several countries. But it is important to note that there have also been bright spots, notably in Mexico and Chile. And better policies in several other countries, including Brazil, Colombia, and Peru have also allowed them to weather the storm reasonable well. I also welcome the stabilization of the economy in Argentina, although the situation remains fragile and there is still a need for a more comprehensive medium-term economic program. Thus, the picture in Latin America is very differentiated. But overall, there are signs of recovery. And this recovery will need to be nurtured, with the right policies and decisive leadership.

But before looking ahead, allow me a short retrospective look:

**What was the cause of the current difficulties facing so many countries in Latin America?**

5. The 1990s started with much promise. After the "lost decade" of the 1980s, many hopes were pinned on reforms, both political and economic. In a great number of countries, the introduction of market-oriented policies paid dividends: in particular, inflation was durably lowered across a continent historically prone to repeated bouts of high inflation. Market liberalization and privatization attracted large volumes of foreign capital, both portfolio and FDI. And for the continent, if not for every country, this paid off in terms of growth: between 1991-97, per capita GDP grew by an average of nearly 2 ½ percent per year, compared to a average annual drop of 1 percent throughout the 1980s. However, since 1998 growth has slowed sharply, and real per capita income levels today are basically back to their levels of 25 years ago.

**So what went wrong?**

6. The debate about the causes of the current crisis is ongoing, and I welcome this debate. But let me say clearly what in my view is <u>not</u> the cause: market-oriented policies. I agree with Ernesto Zedillo, former President of Mexico, who said that the main problem in much of Latin America has not been too much reform, but too little. And I would add: inconsistent policies. Privatization was not adequately supported by a regulatory framework that ensured competition. Fiscal policies were often not consistent with exchange rate policies. And excessive income inequality and the neglect of social safety nets meant that popular support for economic reforms eroded, an issue particularly important for several of the new democracies in Latin America.

7. These policy inconsistencies contributed in many cases to a further weakening in public finances: low levels of tax collection, often as a result of wide-spread tax evasion, and inefficient spending, resulted in rising public indebtedness and weakened the ability of governments to provide critical public services in a number of countries.

8. **Fiscal profligacy and inflation are detrimental for sustained growth and prosperity.** As President Lula da Silva said in his *Letter to the Brazilian People*: "No one needs to teach me the importance of controlling inflation. I began my life in the labor movement indignant about the corrosion of the purchasing power of workers' salaries". But sound macroeconomic policies are not an end in themselves: they represent the government's contribution to a social compact. Ludwig Erhard, who was Germany's Economics Minister and later Chancellor in the 1950s and 1960s, during the so-called German Economic Miracle, always emphasized the need for a *Social Market Economy* to balance the pursuit of free markets with social equity and the principle of moral responsibility of each individual toward the whole of society. It is this balance which the political class in many countries in Latin America has failed to achieve.

9. **It is surely too early to draw definitive lessons from the recent experience in Latin America.** And it would be wrong to suggest that there are one-size-fits-all solutions; each country is quite different. But allow me today to present four reflections on what we have learned and the direction in which I see the way forward for the countries in Latin America.

**First, the economies of Latin America need to be more crisis-proof.** Reducing countries' vulnerability requires sound macroeconomic policies, first and foremost sound fiscal policy: this means a culture of living within one's means, and incurring debt (under reasonable terms) only for productive purposes. Therefore, the efficiency of public administration, and tax and pension reform, need to be high on the agenda in several countries. Experience suggests that more flexible exchange rate regimes are helpful because they provide a buffer for external shocks and facilitate good risk assessment. Furthermore, trade integration in the world economy needs to catch up with financial integration: in many countries in Latin America, capital accounts are currently more open than trade accounts. More generally, there is a need to generate more domestic savings, both by curtailing public indebtedness and by promoting the development of strong domestic financial institutions capable of mobilizing and efficiently allocating financial savings.

10. **Second, sound macroeconomic policies, while necessary, are not a sufficient condition for growth.** Structural reforms are needed to unleash countries' long-term growth potential. There remains significant scope for trade liberalization, which requires considerable efforts in the advanced economies to provide better market access, as well as steps within the region to lower tariff and non-tariff barriers to trade. There is also a need for better public infrastructure and to make the regulatory system more efficient so as to encourage investment, particularly by small and medium-sized enterprises. The World Bank estimates that registering a new business takes 82 days in Brazil, compared to 11 days in Ireland and 2 in the United States. And maybe the most important issue: there needs to be a focus on better access to quality education to build human capital – and as a key instrument in reducing poverty, by providing more opportunity across the social spectrum.

11. **Third, there is an urgent need to strengthen the institutions that support democracy and a functioning market economy.** Empirical evidence points to a clear correlation between the quality of institutions and economic growth. Protecting property rights, upholding the rule of law, and providing sound regulation of product, factor, and financial markets, are crucial elements of a well-functioning market economy. Moreover, strong institutions promote social cohesion and equity, providing necessary stability for economic reform. Hernando de Soto argues powerfully that in many Latin American countries, there is no lack of capital: what is lacking is the legal and judicial infrastructure that allows that capital to be used productively. There is no template of institutions that will work in every country: national traditions will dictate individual solutions. But I have no doubt that promoting a culture of democratic accountability and trust is a critical element in ensuring sustainable long-term growth and social peace.

12. **And fourth, it will be necessary to tackle head-on issues of social equity and poor governance that have bedeviled so much of the continent.** Most measures of income distribution show little or no progress in the past two decades, although there is considerable variation across countries. Macroeconomic stability and stronger, better-functioning institutions will help the poor. But there is also a need to explicitly target policies to alleviate poverty and improve social equity. Public services, such as security, clean water, and health services, provide the basis for human dignity in society, and must be strengthened. Land reform, as successfully restarted with innovative schemes in Brazil and Colombia, can be a powerful tool to reduce rural poverty. And combating corruption will yield significant benefits for economic growth by boosting investor confidence, but will also address social equity issues directly, as it is small businesses and the poor who often bear the brunt of the burden of corruption.

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13. I am convinced that these are critical elements in the way forward for Latin America. And the agenda is achievable. I am particularly encouraged by the new government in Brazil, which is charting a courageous course to restore growth and achieve sustained poverty reduction.

I see three immediate reasons to be optimistic about Brazil:

- First, the smooth and peaceful democratic transition in Brazil provides ample evidence of its political maturity. Former President Cardoso made significant progress in strengthening the institutional framework in Brazil: this provides a good basis for the new government to build on.
- Second, President Lula da Silva is a genuine leader and has defined the right agenda: growth and macro-economic stability <u>with</u> social equity. Strengthening social cohesion is a pre-requisite for Brazil to mobilize its vast resources to yield benefits for all citizens.
- And third, the new Brazilian government has shown the continuity in macroeconomic policies needed to curtail inflation and keep public finances on a steady course. The decision to raise the primary fiscal surplus above earlier planned levels, and to squarely address much-needed social security reform, illustrates Brazil's commitment to live up to its obligations.

14. **While the demands on economic policy in Brazil are clear, there is little room for slippage.** I am encouraged to see the progress that President Lula da Silva has made so far. And we should recognize Brazil's enormous potential. Abundant natural resources and a potentially huge market place of more than 180 million people continue to attract significant foreign direct investment. And the advances in primary education achieved in recent years offer enormous promise for future economic growth. I know that the new government recognizes Brazil's debt problem. But I agree that unleashing the Brazilian people's creativity and thus the growth potential of its economy is the right strategy to tackle it. Indeed, I was struck by the thoughtful and inspiring inaugural speech that Finance Minister Antonio Palocci made upon taking office:

"Ours is an immense country, chained to the rock of stagnation and inequality. [...] Channeling the spirit of construction and renewal by guaranteeing institutions that unite private interest with social welfare must be a central goal of our actions. Institutions matter and the correct design of the rules that govern private and public actions have a core role in enabling us to break the chains that restrain the Brazilian economy and to resume economic growth with more social justice".

The IMF is fully committed to support Brazil in this endeavor.

15. President Lula knows that breaking the chains that are restraining the Brazilian economy is first and foremost the responsibility of Brazil itself. But he rightly asks the international community for help for self-help. And here the main focus needs to be on trade. Brazil's agricultural exports face considerable, and in some cases almost ridiculous, barriers. Take sugar exports to the EU market. Brazilian sugar must pay a tariff of well over one hundred percent on sales in the EU. In addition, European sugar beet producers are subsidized to the tune of around 1½ billion euro in 2002, enough to allow even Finnish farmers to compete with tropical sugar! World Bank estimates suggest that the liberalization of market access under free trade agreements with the European Union and the Americas could raise Brazil's exports by $18 billion, or 32 percent, the vast majority of which would be agricultural products. But we should not forget that Brazil's own trade barriers remain significant in some sectors, severely shackling domestic competition and innovation. These too need to be tackled.

16. **Beyond Brazil and Latin America, trade is also a key to restoring confidence in the world economy.** I am concerned that growth in world trade has slowed considerably, reaching barely 2 percent in 2002, compared with an average annual growth rate of 7 percent during the 1990s. Moreover, the international trading system remains distorted. Markets in which developing countries enjoy a comparative advantage, such as agricultural products and textiles, are among those most protected – and Latin America is among the regions that suffer most from these distortions. The need for change is widely acknowledged but, so far, action has not matched rhetoric. The Doha trade round is entering a critical phase. The WTO's compromise proposal currently on the table is a welcome step. I appeal to the world's leaders to make the Doha Round a success, and to ensure that it is truly a development round. Prime Minister Aznar has shown himself to be a leader in modernizing Spain's economy. Spain's historical ties to Latin America suggest that he could lead in the Doha Round as well, and be a strong advocate for far-reaching reform of the European Union's Common Agricultural Policy.

Ladies and Gentlemen:

17. **I am fundamentally optimistic.** With the right policies, we can return the global economy to a track of sustained economic growth. And my optimism extends to Latin America. There is an enormous potential for growth. And there are leaders who know the way forward. The IMF is committed to work ambitiously with our Latin American members.