Towards Inclusive Development in Latin America and Chile

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The global financial crisis and its economic and social consequences evidenced the importance and urgency of dealing with the challenges of designing a strategy for inclusive and sustainable development. Important issues remain unsolved in Latin America: What should the role of state activism and state financing be in a time of economic crisis? What should Latin America learn from the financial crisis in terms of financial risk and regulation? Is there an appropriate exchange rate policy for countries rich in commodities? What are the future macroeconomic policies that will foster social inclusion? How can the international community better coordinate the macro responses in a legitimate and institutional way; how does the G20 fit in global governance?

These and other crucial questions were addressed by experts and leaders from academic and policy sectors (both international and Chilean) who gathered at the conference titled "Towards Inclusive Development in Latin America and Chile" organized by the Economic Commission for Latin America and the Caribbean (ECLAC), the Initiative for Policy Dialogue (IPD), and the Foundation for European Progressive Studies (FEPS) at the UN CEPAL in Santiago de Chile on August 29th and 30th, 2011.

The conference was part of an ongoing effort of the IPD to stimulate debate on crucial sustainable development issues, as well as FEPS' commitment to foster the discussion of ideas that address key economic issues in a more progressive and equal way. ECLAC's valuable contribution added the necessary knowledge and expertise of the Latin America region to correctly frame this discussion.

This report sums up the most relevant points from the presentations and discussions of the conference. The first section reviews the discussion on the role of the state in financing development, while the second section presents the panel ideas on financial regulation. The third section draws from the panel that addressed foreign exchange rate policies for countries with natural resources. The fourth section summarizes the panel on macroeconomic policies and social inclusion, while the fifth section presents the arguments discussed on the panel on global governance for the G20. The full presentations and discussions of the public panel can also be seen on www.policydialogue.org.

Opening Remarks

In their inaugural speeches, both Ms. Barcena and Mr. Stetter agreed that the demand for inclusive development together with a new global agenda has never been greater. Constant dialogue among relevant progressive actors across regions becomes crucial. Stetter stressed that in order to deal with problems such as the erosion of our welfare systems and the problems of youth unemployment, we must build a new international architecture able to guarantee a fair globalization, while reducing inequalities and ensuring a sustainable development. We must recognize that politics and democratic institutions must orientate and regulate the economy, which is the only way to reconcile capitalism with values of social justice.

In her remarks, Ms. Barcena agreed that equality and fair trade should be the main objectives when striving for inclusive development. The need to rethink economic strategies to better serve social demands is crucial; she highlighted that Latin America is second after China in accumulating international reserves, which mostly ends-up invested in low yield US treasury bills. The region needs to improve its governance of their natural resources and address its funding problem if it wants commodity-driven growth to lead to higher investment and better jobs. Latin America has more political autonomy now than it had before to achieve this and it is possible to set in place new economic structures that could foster south-south trade and intra-region development.

In his intervention, Mr. Lagos highlighted the importance of more and better democracy, translated in long-term policy projects irrespective of who is in office. Citizens should be able to decide which public goods should be provided to all without exception and how much the state should invest in them. As Latin America transitions from a low-income to a middle-income region, the demands will be higher and politicians should step-up to the task. He stressed the need for sustained growth coupled with better income distribution, achieving this via tax, labor, and other fundamental reforms that would put markets to the service of citizens. When referring to the student protests in Chile, Mr. Lagos said that each generation has its own history and that the people who are demonstrating are the children of democracy in Chile, calling for ever more democracy and an educational system that is fairer.

Discussion on the Role of the State in Financing Development

The first panel started with a discussion on how Chile can improve its production structure and achieve higher levels of development by learning from the experience in East Asian countries. Despite all the progress made, Chile remains an unequal society in terms of income distribution and the economy is divided into differentiated and largely unconnected worlds.

For Professor Robert Wade, an important lesson from the East Asian experience (e.g. Japan, South Korea, and Taiwan) is to forget the dichotomy in development economics between export-led growth and import substitution industrialization. The focus, he argued, should be in the complementarities between growth of domestic demand and export demand.

In developing this strategy, the East Asian economies had science and technology advisory groups with foreign experts that would bring to policymakers' attention the developments that were happening outside of East Asia and that gave them suggestions on how these could be linked to or benefit the East Asian development. In addition, a government bureau with engineers as staff would periodically visit factories and ask them how the government could be more helpful. Officials were also always in the lookout for products that companies were importing but that could be produced domestically. For some, the developing strategy did make use of trade protectionism, but tariffs were assigned on the basis of performance.

Osvaldo Sunkel stressed that development in Chile was not entirely fostered by neoliberal policies allowing markets to function freely – despite what international literature may say. Development was the result of deliberate action by the state; examples of this are salmon farming and the pulp and paper industries, which grew thanks to strong subsidies channeled by the Pinochet government and that gave rise to modern businessmen. He argued that development was possible thanks to enormous investments in fixed infrastructure and to a big expansion of consumption based on credit, which raises a concern given the level of indebtedness in some sectors.

For many, the World Bank had been hostile to industrial policy for decades, but now under Justin Lin the Bank has been more sympathetic to a form of it, referred to as structural economics. The vice-presidency of finance and private sector development have began programs for “competitive industries”, and are trying to target resources and lending to these industries that they consider key for development.

The panel agreed that Latin America needs a more active role of the state to propel development, with stronger structures and institutions that allow effective collaboration with different social and economic players and that may use different arrangements, such as Public Private Partnerships. The state should improve its strategic planning capacity, with specialized units and a high technical level to negotiate effectively projects with the private sector.

Of particular importance, according to Sergio Bitar, is education. During the Lagos administration, he mentioned that efforts were done to obtain full coverage in primary and secondary education and that now full coverage is moving to both preschool and higher technical education. An important success was to increase the proportion of youngsters in schools that came from working class families, making merit the condition to access education, not parents’ income level. An important challenge ahead is to maintain higher education affordable, resources are not enough and this insufficiency has triggered the mobilizations and student protests. Investment in human capital, together with sustainable energy and more and better infrastructure are key efforts to overcome the middle income trap.

The panel also discussed long term financing by development banks that should focus on the creation of more and better jobs, better infrastructure, and improved innovation capacities for local companies to compete in global markets. Joao Carlos Ferraz explained that BNDES main objective is to increase investment capacity in Brazil.

A state development financing strategy is even more relevant when there is increasing diversity among countries in the capacity to prosper, amidst a crisis of long duration, when there is fierce competition in all markets for the generation, appropriation and distribution of wealth and when the rate of technical change is extremely fast.

The recent crisis demonstrated the relevance of state activism but “a role model” does and will not exist. However, recent evidence from the 2008-2009 crises does show that besides large domestic markets and proactive public policies, countries less affected by the financial crisis have: a well-regulated financial system and strong public banks. During the 2007-2008 crises, state actions were in an extension and intensiveness never thought of. For example, tax incentives and support to the financial system in developed countries amounted to 48.5% of GDP, while in emerging economies only 2.9% of GDP.

The United States created a regulatory and supervision council, increased the Fed’s controlling powers, and strengthened capital requirements of banks. Efforts are also in place to regulate the over-the-counter derivate market, including credit default swaps. In Brazil, there is a National Monetary Council in place and the Central Bank inspects and regulates the financial sector very effectively; the BIS core capital requirement for banks is 8% and Brazilian banks are required to have 11%.

As market financing is pro-cyclical, a development bank is a stabilizing device, acting with the right scale and scope, following the investment cycle. A development bank is thus an effective contributor to investment and employment with a countercyclical role in the economy.

In Brazil, BNDES is the main provider of long-term financing through different channels such as direct and indirect operations, financing, and providing guarantees for SMEs, export and project finance, among other things. Each nation has its own structure, history, and aspirations and hence development banks are singular institutions that fit differently in every country. Certain features of BNDES, however, provide food for thought for other countries: the flexibility to adapt to change, its “obsession” with investment and development and its capacity to interact with stakeholders, providing political leadership in the country.

Discussion on Risk and Financial Regulation: Lessons from the Financial Crisis

Panelists recognized that the financial system at a national and international level has not worked adequately and has produced costly crises – Europe is beginning a “lost decade” – and the system does not provide sufficient financing for small and medium enterprises, infrastructure, and green energy.

An important lesson from the crisis is the need for a smaller, simpler financial system, not the sophisticated and deregulated one found in developed economies. In the U.S., the financial system represents 40% of corporate profits – it should not absorb so many resources, some should be channeled to the real economy. Present efforts to improve financial regulation, such as Basel III and Dodd-Frank are important but are at risk of being eroded given strong lobby from the banking industry.

Manuel Marfan argued that the exuberance of the private sector and loose banking regulation facilitated credit and asset bubbles. Even though public spending and debt is an important source of vulnerability for countries currently in crisis such as Italy, Spain, Greece, and Portugal, having the fiscal accounts in order is not sufficient. A weak financial system is a source of contingent liability that can prove very expensive for the public sector. Therefore the need for better, stronger regulation.

Roberto Frenkel mentioned that the financial crisis of 2008-2009 that was sourced in the developed world is not that different to the ones Latin American countries experienced in the eighties and nineties. They were all preceded by an economic and financial boom, while financial regulation was weak and financial intermediation surpassed the regulatory capacity of these countries. A specific conclusion for developed and developing countries alike is, however, that preventing crisis requires a macroeconomic policy that includes a flexible exchange rate policy, specific policies related to the management of balance of payments, adequate levels of international reserves, and measures that allow regulation of capital flows.

Latin America, points out Stephany Griffith-Jones, should not be complacent by its success in escaping the financial crisis of 2008. Three years later, the crisis is still present and prospects are it will last for a long time, raising the risk of contagion. Since there is a lot of foreign banking in Latin America, it could be a source of instability rather than stability.

Roberto Frenkel added that even though the probability of a financial and external crisis in emerging markets is very low, the challenge they face is to neutralize or alleviate the effect of capital inflows in their economies. The massive free capital inflows into emerging economies creates a prolonged period of currency appreciation that could potentially have negative effects on growth, industrial production, and employment. Many of the capital flows into industries is highly reversible and the loss in competitiveness resulting from high currency appreciation produces permanent destruction in human and organizational capital. Therefore, prudence in the treatment of the real effects of a prolonged currency appreciation is recommended even when terms of trade and financing conditions are favorable.

Before the financial crisis, developing countries had the vision that big foreign banks setting up in their financial systems would be a source of both, stability and resources. The crisis showed that in some instances banks were a channel for contagion and that resources were withdrawn from the subsidiaries to the headquarters to increase their capital. Regulation to curtail this practice should also be in place in emerging economies.

Worldwide, financial regulation should require higher capital and liquidity levels from banks. Higher capital requirements would increase buffers during crises and would also help prevent future ones, by limiting credit growth. Regulation should also be counter-cyclical, requiring increases of provisions and capital during boom periods and reducing requirements during busts, allowing smoothing the credit and economic cycle. For counter-cyclical policies to work, rules should be clear ex-ante to avoid loose interpretations of them during booms. Regulation to reduce domestic and foreign currency mismatches in banks' balance sheets is equally important.

The overhaul of the system should be comprehensive, including the financial activities of the non-financial institutions. If this is not the case, there will always be scope for regulatory arbitration, particularly given that banks increasingly manage operations off their balance sheets for tax and regulatory purposes. This was at the center of the financial crisis and has not been completely addressed.

Discussion on Exchange Rate Policy for Economies with Natural Resources

Nicolás Eyzaguirre's global base case scenario assumes continued growth with diminishing downside risks. Growth in Europe and the U.S. will continue to be slow, given the prolonged deleverage process of households and corporations and governments' austerity programs. China, on the other hand, will continue to be decoupled from these effects while generating high commodity prices that boost growth in Latin America. The LATAM region will also benefit from cheap external financing, although with higher uncertainty and risk aversion.

Under this scenario, the right policy mix in Latin America should consider overheating risks and the accumulation of vulnerabilities. The region must reconstruct defenses (international reserves, fiscal savings) that were used in 2008-09 before they must be used again. Governments should implement prudent macroeconomic policies that include a better fiscal framework (e.g. a fiscal rule) and policies that address an excessive appreciation of the exchange rate. An over-appreciated currency is a reflection of a current account deficit that is vulnerable to sudden stops and causes volatile GDP growth that may reduce medium-term potential growth. Important to note, however, that despite the vulnerabilities created by sustained currency appreciation, there is still inconclusive evidence pointing to a Dutch disease in Latin America.

Since governments have started to consolidate their fiscal positions after the financial crisis, they should be mindful of minimizing the impact in potential growth, maintain social programs (targeting the poor), and assure social cohesion (targeted to the middle classes). Fiscal retrenchment should avoid compromising infrastructure and education expenditure and should focus on reducing and improving the structure of spending. These efforts could be coupled with a better taxing structure, since the current one typically involves a very low tax base and regressive elements.

Ricardo Ffrench-Davis agreed with the idea that currency appreciation is a source of vulnerability. He stated that the average level and the degree of stability of the exchange rate affects – now more than ever – the composition of exports and the local production of tradable goods.

The way in which an exchange rate policy affects development is the following: during booms, the exchange rate tends to appreciate, convincing market participants that it is a persistent tendency and discourages gross capital investment in tradable goods. During busts, the exchange rate depreciates, uncertainty prevails and capital markets are tight, limiting capital investment in tradable goods.

In the last years, cyclical capital flows and changing terms of trade in Latin America have discouraged investment in exports with higher value added and have weakened their connection with the rest of the economy, diminishing the production of tradable goods. As a result, counter-cyclical regulation to smooth capital flows is needed. Governments should also consider, and many are already doing so, a stabilization fund for export revenues, helping to stabilize fiscal expenditure and the exchange rate. This is paramount to avoid unbalanced growth that significantly affects the composition of aggregate demand. For example, between 2006-07, Aggregate Demand in Chile grew 8-10% annually, but effective demand (for local goods in the domestic market) increased less than 4%.

Discussion on Macroeconomic Policies for the Future and Social Inclusion

The panel discussion among Roberto Zahler, YV Reddy, and Jose Antonio Ocampo focused on the broad macroeconomic lessons from the recent financial crisis and on the policy implications the current macro environment has for the Latin American region. The nature of the risks now is different from the ones faced in the pre-crisis period and policymakers should adjust accordingly.

The current global macroeconomic environment includes a strong and prolonged liquidity expansion not only by the US Federal Reserve, but also by the ECB and the Central Banks of England and Japan. These policies intend, among other things, to liquidate the public debt of these countries but are also translated into higher international inflation that affects emerging economies. Another effect of these policies is the depreciation of the US dollar and other strong currencies, creating appreciation pressures in emerging countries, particularly in the ones that have a flexible exchange rate policy. In Latin America, this effect is widely observable in Brazil, Chile, Colombia, Peru and to a lesser extent, Mexico.

One main consequence is currency appreciation that hinders the tradable sector of the affected emerging economies, since the appreciation is due to international market dynamics rather than a reflection of rising domestic productivity. This in turn causes a current account deficit that may be unsustainable. Moreover, the more the receptors of excess global liquidity are successful in curtailing their effect in their currencies, the higher the risk of directly importing international inflation, increasing excessive domestic credit and experience higher asset prices in non-tradable goods.

The adequate policy response depends on a rigorous evaluation of the main cause that led to currency appreciation. If the origin of the problem stems from deteriorating terms of trade, then policy should act on the current account of balance of payments. Large current account deficits may contain risks of instability, though the right level of current account deficit cannot be easily defined. If the cause of the problem is derived from excessive capital flows, the policy should deal directly with the capital account.

The macroeconomic policy response should come from different fronts. Fiscal policy should not only maintain the public sector deficit and debt levels in a sustainable level, but also have a critical role in the overall counter-cyclical public policy, coordinating with monetary policy as well as with financial sector regulation and policies relating to open capital account. On the other hand, monetary policy should have as main objective the control of inflation but should also regulate the level of asset prices and the evolution of the real exchange rate.

The policy of accumulating international reserves can also contribute to mitigate the vulnerability of the country to possible international turmoil and the effect of a sudden stop. An adequate buffer in the form of reserves facilitates establishing liquidity lines in foreign exchange for the internal financial sector, in a credible and expedite manner for significant amounts.

In addition, policies designed to foster capital outflows should be established considering the contribution capital has in internal savings and the risk they represent to the system, as well as their portfolio diversification, but not based in their impact on the exchange rate or other short term considerations. Curtailing capital inflows is justified when the aforementioned policies cannot be applied in the desired magnitude or velocity. Its main limitation is the ability of “creative” financial engineering to evade the policy.

Macro-prudential policies should seek to reduce systemic financial risk. Financial institutions’ provisions that have an anti-cyclical component are dynamic and act as automatic stabilizers that mitigate the pro-cyclicality of standard provisions. Capital requirements, on the other hand, should be linked to credit growth, with different requirements depending on the type of risk assets. In addition, macro-prudential policies should include limits to maturity and currency mismatches, applied after a sensibility test.

Finally, governance has been found to be wanting in both public sector and private sector institutions. There should be preference to emphasize coordination in public policy and ensuring that institutional mechanisms exist in private sector to minimize both, the chances of conflict of interest and incentives towards excessive risk taking.

During his presentation, YV Reddy highlighted the important lessons from the Indian experience, namely the need for changes in thinking, to keep pace with global and domestic developments alike and the importance of going beyond the financial sector and give importance to macroeconomic factors.

In India, for example, despite pressures to the contrary, denomination of marketable sovereign debt (including sub-national debt) in foreign currency was avoided and holding of such debt by non-residents was severally restricted. At the outset of the crisis, the central bank had in place a full range of instruments to manage counter-cyclical policies and pressures on liquidity in money and foreign exchange markets.

The Indian experience also has several unique innovations, such as a Market Stabilisation Scheme and financial inclusion. The pre-dominance of public sector banks helped in reducing the problem of information asymmetry in regulation, but added to the problem of behest lending and some dilution in transmission of policy. In brief, the monetary and regulatory policy in India was active and innovative, while in many other countries, it was passive.

Global Governance Proposals for the G20

The final presentation included the participation of Alicia Barcena, Stephany Griffith-Jones, YV Reddy and former President of Chile, Ricardo Lagos.

Panelists agreed that, given that we are still in crisis, there are issues that need to be solved immediately. Finding a common fiscal solution in Europe is crucial, and finding monetary and fiscal solutions that focus on medium-term growth and employment should be at the center of the discussion. Proposals such as the issuance of an euro-bond or SDR-bonds should also be at the table, rather than further quantitative easing by the FED or ECB.

During the discussion, it was mentioned that the substantial accumulation of international reserves by developing countries should be put to better use, and that it is possible to use them for liquidity lines and to finance a development bank. “If we use 1% of the sovereign funds by developing countries, we could create a bank that has the capacity to lend more than all of the regional banks of the world,” Stephany Griffith-Jones stated.

The panelist remembered how was that the G20 took the center stage in global governance: it was when former President Bush summoned G20 leaders to go to Washington as Lehman Brothers collapsed and the world crisis worsened. The financial crisis was a watershed and made it clear that the G20 is here to stay. Back then, the starting agenda was very promising, it included among other things, international and national financial regulation. After that, the implementation has been very weak but countries broadly agreed in principle with the agenda. Notable changes did occur, after the Spring 2009 London meeting the G20 conferred the IMF the role to issue US$ 250 billion – for years, Stephany Griffith-Jones says, we fought for a US$20 billion issuance and we were called extremists!

Prof. Griffith-Jones added that at the G20 working group on how to finance poor countries none of those countries were actually at the table, but that the debate was very different from the ones experienced with the G7 because China and India were there – the developing world had indeed more opportunity to drive the discussion.

The truth is that the global institutions that we have now were created in 1945 and need to be adapted to our new global reality. Alica Barcena argued that the G20 should stick to what it was created for: economic issues. Despite the importance of climate change and the urgency to address it, the G20 is not the appropriate forum for this and other discussions. The problem with the G20 is that it is not representative and it is not the official institution for these matters. The United Nations is the most appropriate forum but it needs to be strengthened, by setting for example an Economic Security Council that could be linked to a Political Security Council, given that the Security Council in the UN is the only agency that has "teeth". The key dilemma world leaders face is either empowering the G20, to the extent that it undermines existing official institutions, or empowering the existing institutions to the point where they can no longer be undermined by the G20.

President Lagos stated that despite its legitimacy problems, the G20 is here to stay and there are significant improvements in terms of inclusion if compared to former only-G7 discussions. Griffith-Jones pointed out that if Latin America wants to play a more important role in global governance issues, it should not contribute to freeze the G20 structures. Latin America has a good opportunity to contribute since they have three countries in the group.

President Lagos further stated that one of the issues is to deal with the new role of the IMF. The UN Charter established that the Bretton Woods institutions would exist under the control of the UN, and therefore it is important to reestablish this relation and have Bretton Woods Institutions do what they were supposed to do, without the need of changing the Charter. The IMF has never reported to the UN economic council what it is doing. If this arrangement is restored, the G20 won't be an institutional/formal entity but it can still help coordination. In addition, an important lesson that should be incorporated in the new governance institutions is that power should be used collectively, never unilaterally – the wars after 9/11 demonstrated this clearly.

In Latin America, President Lagos stresses that institutions such as UNASUR and old Rio must be capable of reaching agreements so the region can speak in concert. If Cristina Fernandez, Dilma Rousseff and Felipe Calderon can come together and speak for Latin America it is not bad; there are a set of issues in the multilateral sphere that are best resolved at this level. Therefore, from a regional viewpoint, it is essential to make Latin American institutions work so they can exert greater influence on global governance.